hydroOne

RENEWAL ANNUAL INFORMATION FORM

FOR THE YEAR ENDED DECEMBER 31, 2006

FEBRUARY 16, 2007

HYDRO ONE INC.

ANNUAL INFORMATION FORM
FOR THE YEAR ENDED DECEMBER 31, 2006

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Except where otherwise indicated, all information presented herein is as at December 31, 2006.

DEFINITIONS

For convenience, in this Annual Information Form:

"**CDM**" means conservation and demand management;

"**GTA**" means the Greater Toronto Area;

"**Hydro One**", "**our company**", "**we**", "**us**", and "**our**" refer to Hydro One Inc. and its subsidiaries and predecessors, except where the context requires otherwise;

"**IESO**" refers to the Independent Electricity System Operator, previously named the Independent Electricity Market Operator;

"**IPSP**" means the Integrated Power System Plan being developed by the OPA;

"**Market Rules**" means the rules made under Section 32 of the *Electricity Act, 1998* that are administered by the IESO;

"**OEB**" refers to the Ontario Energy Board;

"**OEFC**" means the Ontario Electricity Financial Corporation;

"**OGCC**" means Hydro One's Ontario Grid Control Centre located in Barrie, Ontario;

"**Ontario**" refers to the Province of Ontario as a geographical area;

"**OPA**" refers to the Ontario Power Authority;

"**Open Access**" refers to the opening of Ontario's wholesale and retail electricity markets to competition which officially occurred on May 1, 2002; and

"**Province**" refers to the Government of the Province of Ontario.

CORPORATE STRUCTURE

Hydro One Inc. was incorporated as Ontario Hydro Services Company Inc. by Articles of Incorporation dated December 1, 1998 under the *Business Corporations Act* (Ontario). On May 1, 2000, we changed our name to Hydro One Inc.

Our registered office and head office is located at 483 Bay Street, 15th Floor, North Tower, Toronto, Ontario, M5G 2P5.

The following are our principal subsidiaries, each of which is wholly-owned by us and is incorporated under the laws of Ontario:

- Hydro One Networks Inc. — carries on all business relating to our ownership, operation and management of electricity transmission and distribution systems and facilities;

- Hydro One Brampton Networks Inc. — carries on the business relating to our ownership, operation and management of electricity distribution systems and facilities in Brampton, Ontario;

- Hydro One Remote Communities Inc. — carries on all business relating to our ownership, operation, maintenance and construction of generation and distribution assets used in the supply of electricity to remote communities throughout Northern Ontario; and

- Hydro One Telecom Inc. — carries on all of our business relating to leasing dark fibre and providing lit telecommunications capacity to other telecommunication carriers, large corporations, government, healthcare, and education institutions.

FORWARD-LOOKING INFORMATION

This Annual Information Form contains, and Hydro One's oral and written public communications often contain, forward-looking statements that are based on current expectations, estimates, forecasts and projections about the business of Hydro One and the industry in which Hydro One operates and includes beliefs and assumptions made by the management of our company. Such statements include, but are not limited to, statements about the general development of our business; recent regulatory developments including the requirement to install smart meters and the expected costs to Hydro One; the expected impact of CDM programs and the IPSP; the expected completion of inter-tie projects; our strategy as it relates to safety, customer satisfaction, reliability, productivity and cost efficiency; expectations regarding key capital expenditures including investments in our distribution, transmission and telecommunications businesses; expectations regarding developments in the statutory and operating framework for electricity distribution and transmission in Ontario including changes to codes, licences, rates, rate orders and rate structures in both our transmission and distribution businesses; expectations regarding borrowing requirements; expectations regarding future pension contributions; expectations regarding environmental expenditures and other environmental matters; the nature of our relationship with the Province; expectations regarding workforce demographics and retention of key personnel; expectations regarding our strategy for acquisitions or divestitures of distribution assets; and legal proceedings in which we are currently involved. Words such as "expect," "anticipate," "intend," "attempt," "may," "plan," "will," "believe," "seek," "estimate," and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve assumptions and risks and uncertainties that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, implied or forecasted in such forward-looking statements. Hydro One does not intend, and Hydro One disclaims any obligation to update any forward-looking statements, whether written or oral, or whether as a result of new information, future events or otherwise except as required by law.

These forward-looking statements are based on a variety of factors and assumptions including, but not limited to: no unforeseen changes in the legislative and operating framework for Ontario's electricity market; favourable decisions from the OEB concerning outstanding rate and other applications; no unforeseen changes in rate orders or rate structures for our distribution and transmission businesses; a stable regulatory environment; and no significant event occurring outside the ordinary course of business such as a significant adverse change to the financial markets or a natural disaster or other calamity. These assumptions are based on information currently available to Hydro One including information obtained by Hydro One from third-party industry analysts. Actual results may differ materially from those predicted by such forward-looking statements. While Hydro One does not know what impact any of these differences may have, its business, results of operations, financial condition and its credit stability may be materially adversely affected. Factors that could cause actual results or outcomes to differ materially from the results expressed or implied by forward-looking statements include, among other things:

- the risks associated with being controlled by the Province including potential conflicts of interest that may arise between us, the Province and related parties;
- the risks associated with being subject to extensive regulation including risks associated with OEB action or inaction;
- the potential impact of not being able to recover all of our project costs associated with the installation of smart meters;
- the potential impact of CDM programs on our load, in particular transmission;
- the potential for service disruptions and increased costs if we fail to maintain and improve our aging asset base;
- public opposition to and the failure to obtain all necessary approvals and accommodations at all or in a timely manner for projects necessary to increase transmission capacity;
- the risks related to the high number of retirements anticipated over the next few years and our potential inability to attract and retain qualified personnel;
- the inability to further improve our labour productivity and the potential for labour disputes;
- the potential for substantial and currently undetermined environmental costs and liabilities;
- the risks to our facilities posed by severe weather, other natural disasters or catastrophic events and our limited insurance coverage for losses resulting from these events;
- the risk that we are not able to arrange sufficient cost effective financing to repay maturing debt and to fund capital expenditures, dividends and other obligations;
- the risk that we may be required to make substantial contributions to our pension plan;
- the risk that we may be subject to significant costs to complete the transfer of transmission, distribution and other assets located on Indian lands;

- the impact of the acquisition by the Province of owned lands underlying our transmission system;
- the risks associated with developing, maintaining and managing a complex information technology systems infrastructure;
- the potential that we may incur significant expenses to replace some or all of the functions currently outsourced if our agreement with Inergi LP is terminated; and
- the risks associated with changes in foreign exchange and interest rates.

Hydro One cautions you that the above list of factors is not exclusive. Some of these and other factors are discussed in more detail under "Risk Factors" in this Annual Information Form. You should review the section entitled "Risk Factors" in detail.

GENERAL DEVELOPMENT OF THE BUSINESS

We are wholly owned by the Province and our transmission and distribution businesses are regulated by the OEB. Our industry, including our company, is governed within the broad legislative framework of the *Electricity Act, 1998* and the *Ontario Energy Board Act, 1998*, as amended.

The *Electricity Act, 1998* and the *Ontario Energy Board Act, 1998* were significantly amended by the Province during 2002. The *Reliable Energy and Consumer Protection Act, 2002*, which received Royal Assent and came into force on June 27, 2002, among other matters, clarified the Province's rights to acquire, hold, transfer, dispose of or otherwise deal with securities, debt obligations of, or any other interest in, Hydro One and transferred, effective December 31, 2002, ownership of the transmission corridor lands from Hydro One to the Province in exchange for a statutory right to use the land for transmission and distribution purposes.

Commencing on March 1, 2004, distributors were permitted to start recovering certain distribution regulatory assets in their rates. Accordingly, in January 2004, we filed an application with the OEB for approval of distribution rate adjustments reflecting recovery of these regulatory assets for the period from Open Access to December 31, 2003. Final approval was given by the OEB on December 9, 2004. Based on this final order, we implemented rate adjustments on April 1, 2005 to recover the approved amounts.

Regulated Price Plan Structure

On April 1, 2004, the OEB implemented an interim two-tiered rate structure for the cost of electricity supplied to low volume and designated customers based on a consumption threshold of 750 kWh. On April 1, 2005, the OEB implemented a new regulated price plan structure for the cost of electricity supplied to low volume and designated customers ("RPP"). The RPP only regulates the commodity price of electricity and does not affect the rates charged for transmission and distribution of electricity and thus has minimal impact on Hydro One. The RPP maintained the two-tiered pricing structure established in 2004 but also introduced seasonal consumption thresholds. For residential customers, the price threshold is 600 kWh per month in the summer and 1,000 kWh per month in the winter. For non-residential customers, the price threshold is 750 kWh per month in both the summer and the winter. A summary of the prices and consumption thresholds set by the RPP are as follows:

Residential Customers Under the RPP		
Winter (Nov. 1, 2005 – April 30, 2006)	Up to 1,000 kWh	5.0 cents
	More than 1,000 kWh	5.8 cents
Summer (May 1, 2006 – Oct. 31, 2006)	Up to 600 kWh	5.8 cents
	More than 600 kWh	6.7 cents
Winter (Nov. 1, 2006 – April 30, 2007)	Up to 1,000 kWh	5.5 cents
	More than 1,000 kWh	6.4 cents
Non-Residential Consumers Under the RPP		
Winter (Nov. 1, 2005 – April 30, 2006)	Up to 750 kWh	5.0 cents
	More than 750 kWh	5.8 cents
Summer (May 1, 2006 – Oct. 31, 2006)	Up to 750 kWh	5.8 cents
	More than 750 kWh	6.7 cents
Winter (Nov. 1, 2006 – April 30, 2007)	Up to 750 kWh	5.5 cents
	More than 750 kWh	6.4 cents

The OEB sets prices under the RPP at least once every 12 months, and may, upon review, reset prices more frequently to reflect updated price forecasts as well as to pass through any accumulated unexpected shortfalls or overpayments associated with the RPP. The OEB currently plans to review the need to reset prices every six months.

Ontario Power Authority

The *Electricity Restructuring Act, 2004* came into force in December 2004. It was enacted to ensure the adequacy, safety, sustainability and reliability of electricity supply in Ontario, facilitate load and demand management, encourage conservation and efficiency and regulate prices in parts of the electricity sector. In addition, the legislation created the OPA. The OPA's mandate is to ensure the adequacy and efficiency of electricity supply in the Province through planning of electricity supply and demand. See "Regulation – The Statutory and Operating Framework" for further information.

The OPA issued its Supply Mix Advice Report, which provides advice on future generation options for Ontario, on December 9, 2005 to the Minister of Energy. The Minister issued a directive to the OPA on June 13, 2006 providing direction as to the preparation of the IPSP. The Minister's directive on the IPSP included directions to strengthen the transmission system to enable the achievement of the supply mix goals set out in the directive, to facilitate the development and use of renewable energy resources in parts of the Province where the most significant development opportunities exist, and promote system efficiency and congestion reduction and facilitate the integration of new supply consistent with the need to cost-effectively maintain system reliability.

As part of the analysis and stakeholder consultation process performed in preparing the IPSP, the OPA released and circulated a series of eight discussion papers for comment. The discussion papers deal with such issues as the scope of the IPSP, the load forecast, CDM issues, supply resources, procurement options, and, of particular relevance to Hydro One, transmission issues. Discussion Paper #5: Transmission, released on November 13, 2006, assesses the present state of the transmission system in Ontario, forecasts its evolution over the next twenty years and provides recommendations on the development of 45 specific transmission projects over that timeframe. Also relevant to Hydro One is Discussion Paper #7: Integrating the Elements – A Preliminary Plan, released on November 15, 2006. Discussion Paper #7 integrates the elements discussed in each of the prior discussion papers, including the recommendations relating to load forecasting, CDM issues, supply resources, and the transmission projects referred to in Discussion Paper #5, and presents a preliminary 20-year IPSP for purposes of stakeholder discussion and feedback. The OPA recognizes that the preliminary IPSP is a work in progress that is designed to increase stakeholder understanding about the various considerations involved in developing the plan, and the OPA's intent is to further refine the preliminary IPSP into the plan that will be submitted to the OEB.

The OPA is expected to submit the final IPSP to the OEB for review and approval in 2007. The OEB may take up to a year to complete its review.

Smart Meters

The *Energy Conservation Responsibility Act, 2006* provides the framework for the installation by all electricity distributors of 800,000 smart meters by December 31, 2007 and the installation of smart meters in all homes and small businesses in Ontario by December 31, 2010. Under the legislation, a new entity will oversee the communications systems and technologies, collect and manage data, and may facilitate meter procurement. To date, no entity has been appointed. On July 26, 2006, the Ministry of Energy announced that they entered into an arrangement with the

IESO whereby the IESO will support the Province's smart metering initiative by coordinating and managing implementation activities.

Hydro One Network Inc.'s proportionate share of the 800,000 meters required to be installed by December 31, 2007, is 240,000. These meters are expected to be capable of measuring and reporting usage over predetermined periods, being read remotely, and providing customers with access to information about their electricity consumption. Smart meters are regarded by the Province as an integral means of promoting a culture of conservation.

Planned smart meter activities are still at an early stage. The current dynamic state of smart meter and communication technologies, especially with respect to rural applications, will likely change the cost estimates of deployment beyond 2007. Total project costs are anticipated to be significant. In 2007, we plan to invest approximately $75 million under our smart meter program and install 240,000 meters. At the Province's request, we will review our implementation plan and associated costs for the period from 2008 to 2010.

On March 21, 2006, the OEB approved a monthly rate of $0.30 per residential customer, effective May 1, 2006, as initial funding for the required investment in smart meters. Our distribution rate application is expected to be filed with the OEB in February 2007 and will include a request to increase the monthly rate per residential customer for smart meter funding.

There may be an opportunity to leverage the smart meter infrastructure for smart network initiatives such as CDM, load control distribution operations automation and mobile technology. The benefits of a smart network will be assessed and included in our future investment plan as appropriate.

Conservation and Demand Management

The Province has established specific targets for CDM and Hydro One's distribution businesses have built expenditures into their plans to meet these targets. In May 2004, the Province authorized local distribution companies, including Hydro One, to apply to the OEB for the third installment of their allowable return on equity beginning March 1, 2005. The Province also indicated that the approval of the OEB would be conditional on a financial commitment to reinvest an amount equal to one year of the incremental returns in CDM initiatives. For Hydro One Networks Inc. and Hydro One Brampton Networks Inc., the total CDM revenue available was approximately $42.7 million. Hydro One submitted CDM plans for this full amount to the OEB on January 11, 2005. On February 18, 2005, Hydro One received approval of its CDM plan on behalf of Hydro One Networks Inc. on the condition that, among other things, planned spending on smart meters for 2006 ($7.1 million) be re-directed to other projects. On November 1, 2005 the revised plan was approved as filed, enabling total expenditures of $39.5 million. On February 18, 2005, Hydro One Brampton Networks Inc.'s plan for $3.2 million in CDM spending was also approved as filed. On February 2, 2005, Hydro One Remote Communities Inc. received interim approval, as requested, for a CDM plan for $300,000. The OEB requires each distributor to file an annual report including a cost-benefit analysis by March 31 of each year in respect of the results of the previous year.

On July 13, 2006, the Ministry of Energy issued a directive to the OPA regarding the OPA assuming responsibility for organizing the delivery and funding of CDM programs through electricity distributors in Ontario. The directive recognized that distributors have a role as delivery agents for CDM and that funding for their programs should be secure, stable and multi-year.

The directive provides guidance on key funding aspects of CDM for distributors as follows:

1. The OPA will begin organizing the delivery and funding of CDM programs through distributors immediately, with implementation of funding to occur in the earliest practical timeframe.
2. The funding will be limited to a total of $400 million over three consecutive years.
3. Distributors would contract to deliver programs funded by an OPA-administered distributor fund on a non-competitive basis in their service territory.
4. These funds will not include provisions for smart meters.
5. The OPA should support the OEB in its continuing efforts to reduce barriers to CDM including decreases in revenues due to distributors' conservation programs.

The OPA plans to have a final plan on its approach to CDM submitted to the OEB for approval during 2007.

Government and OPA Procurement of New Generation

Over the last few years, the Province and the OPA have sought to procure new generation in Ontario. Hydro One continues to work with successful proponents under various Ontario government and OPA procurements of new generation in Ontario including the Renewables RFPs, the 2,500 MW Clean Energy RFP, the acquisition of new gas generation in the western part of the GTA and downtown Toronto, and the Combined Heat and Power RFP. Hydro One has placed a high priority on connecting these new sources of supply reliably and in a timely fashion.

Hydro One is dealing with a heavy workload driven by close to 700 applications in 2006 for assessment of proposed new small renewable generation connections to our distribution system. Work continues on hiring and training new staff to increase Hydro One's capability to perform these assessments.

Additional procurements by the OPA are likely and Hydro One's strategy and processes for dealing with the existing and anticipated connections is evolving to ensure that we are able to respond as effectively as possible. See "Risk Factors – Risks Associated with Transmission Projects."

Electricity Transfer Tax Exemption

In October 2006, the Province announced that publicly-owned utilities will be exempt from paying the electricity transfer tax when they sell electricity distribution assets to other public utilities in Ontario. The normal transfer tax payable is equal to 33% of the fair value of the municipality's interest in electricity assets transferred to another entity. The transfer tax exemption became effective on October 17, 2006 and is to last for two years. The Province indicated that the transfer tax exemption was designed to promote investment and efficiencies among Ontario's publicly-owned electricity utilities. The Province also plans to lift the moratorium on the purchase and sale of electricity distribution assets by Hydro One, with the understanding that any future asset purchases or dispositions help further overall efficiency in the sector. We will respond, on a voluntary and commercial basis, to opportunities to purchase or divest assets where they are consistent with corporate strategy. Our investment plan does not include any funding for acquisitions or divestitures.

DESCRIPTION OF THE BUSINESS

Overview

We are the leading electricity transmission and distribution company in Ontario. We own and operate substantially all of Ontario's electricity transmission system, accounting for approximately 97% of Ontario's transmission capacity as measured by revenues for the year ended December 31, 2006. Our transmission system is one of the largest in North America based on assets as at December 31, 2006. Our distribution system is the largest in Ontario based on assets as at December 31, 2006 and spans approximately 75% of Ontario, serving approximately 1.3 million customers. We have three reportable segments: (1) our transmission business; (2) our distribution business; and (3) our other business.

Our transmission business, which represented approximately $6.97 billion of our total assets of $12.23 billion as at December 31, 2006, transmits electricity through an approximately 28,600 circuit-kilometre high-voltage network. We transmit electricity from generators to our own distribution networks, 51 local distribution companies and 64 large industrial customers directly connected to our transmission system. We also own and operate 26 facilities that interconnect our transmission system with systems in neighbouring provinces and states.

Our distribution business, which represented approximately $5.17 billion of our total assets of $12.23 billion as at December 31, 2006, distributes electricity through our approximately 124,700 circuit-kilometre low-voltage distribution system, including phase multipliers, to municipalities and in rural areas. Customers of our distribution business include 34 local distribution companies that are not directly connected to our transmission system, 48 large industrial customers and approximately 1.3 million rural and urban customers. Hydro One Brampton Networks Inc. is our urban distribution company, serving approximately 120,000 customers in the GTA with approximately 4,845 circuit-kilometres of lines with phase multiplier. We also operate through our subsidiary, Hydro One Remote Communities Inc., 18 small, regulated generation and distribution systems in 20 remote communities across Northern Ontario that are not connected to Ontario's electricity grid.

Our other business segment is primarily represented by the operations of Hydro One Telecom Inc. This subsidiary markets dark and lit fibre-optic capacity to telecommunications carriers and commercial customers with broadband network requirements. The assets of this segment constituted approximately $99 million of our total assets of $12.23 billion as at December 31, 2006.

The OEB regulates our transmission and distribution businesses and issues rate orders to establish the revenue requirements required to cover the approved costs of these businesses plus a specified rate of return. See "Regulation – Rate Orders and Related Issues for Hydro One's Businesses – Transmission – Current Rate Orders and Distribution Rate Structure."

Recent Development

Agency Review Panel

On January 29, 2007, the Minister of Energy established a four-member panel to recommend new and updated methods of determining compensation arrangements for top provincial energy sector executives. The panel will be led by James Arnett and will also include Dave Cooke, Charles Harnick and Sharon Manson Singer. The Province is looking to the panel to recommend compensation arrangements that are more in line with comparable public energy organizations in other jurisdictions. New criteria for compensation would be reflected in future contracts of top executives. The panel will also be asked to report back to the Province on areas where energy sector effectiveness can be further strengthened, including assessments of overlap and duplication between agencies, and whether sufficient steps are being taken to address concerns about potential future shortages of skilled workers. The panel is expected to report back to the Minister with its findings concerning executive compensation arrangements in late spring of 2007. Further recommendations to strengthen energy sector effectiveness are expected to follow thereafter.

Our Strategy

In 2006, we maintained our strategic focus on our core operations and built upon our accomplishments. Our goals are to be recognized by our customers as their best service provider; by our peers as their benchmark for excellence; and by our shareholder as delivering superior value. We seek to achieve these goals by continuing to implement the following strategies:

- *Safety:* Create and maintain an injury-free workplace with a concentrated focus on elimination of serious injury and "near misses" in high potential harm categories of work.

- *Customers:* Become a leading customer-focused company. We intend to maintain our focus and commitment to improving our customers' level of satisfaction. We strive to strengthen relationships with our large and mid-sized customers acknowledging their commercial requirements. For residential customers, our key focus is on improving the quality of customer services such as billing, call handling, outage management and meter reading. We also aim to make positive contributions in communities across Ontario through our corporate citizenship programs.

- *Reliability:* Enhance the reliability of our transmission and distribution systems. In transmission, we have assumed a proactive leadership role in developing the system to meet Ontario's power needs. Within distribution, we are focused on reliability while recognizing the challenges in operating a system with low customer density and vast geography.

- *Financial:* Ensure our actions contribute towards maximizing the value of our company, while maintaining effective access to funds on a long-term basis at reasonable rates and delivering appropriate financial returns to our shareholder.

- *Employees:* Manage the challenges of labour demographics by attracting, developing and retaining productive employees.

Focusing on safety

Given the nature of our work and extreme weather conditions encountered at times, safety is of paramount importance. Our top strategic priority is to eliminate serious injuries and "near misses" that have the potential to cause serious injury. Several existing strategic initiatives that were endorsed in 2006 by our company are expected to continue and a number of existing programs are expected to be strengthened over the planning period in order to achieve and sustain the required cultural change. These initiatives include an increased focus on incident prevention and job planning, a comprehensive health and safety management system, effective management and control programs for hazardous materials and a managed system for follow-up arising from incidents and "near misses." Our increased focus on safety is expected to enhance productivity while providing a safer work environment.

Continuing to improve our customer service focus

We are focused and committed to improving our customers' level of satisfaction. For example, we have been actively helping our customers understand the changing industry structure, changes affecting their bills, the increased priorities on CDM, and our role in ensuring adequacy and security of supply.

For our distribution connected residential and seasonal customers, we have maintained the capability and capacity of our call centre to meet customer needs and to provide fast telephone response time and we have also expanded the services offered through our website. We have begun our roll-out of smart meter installation to provide the basis for creating an energy conservation culture across Ontario and help customers better manage their electricity use. We provide extensive customer communications to address their information needs by providing our agents with faster access to customer information and reducing the risk of telephone system failure. We utilize our Outage Response Management System to give customers better information on local outage restoration efforts.

For our generation customers, we have streamlined, consistent with the requirements of the OEB's Distribution System Code and Transmission System Code, the processes for connecting new generators to our transmission and distribution systems.

For our mid-size business customers, we continue our assignment of our Field Superintendents to manage the customer relationship. We have found that this local presence has improved our responsiveness to our customers' needs.

For our large transmission connected industrial customers and local distribution companies, we continue to have a dedicated account executive for each account over 5 MW of load. In addition, we have made a senior member of management available for our largest 35 customers. This gives each of these customers a senior internal contact which we believe fosters an improved relationship.

Reliability

The two prime goals of our transmission and distribution capital program over the next few years are:

- to improve, where required, the condition of our assets and to maintain them in such a manner to ensure good performance and to ensure they continue to meet reliability requirements; and
- to invest in new assets required to meet Ontario's power needs.

Transmission

We are currently top quartile in transmission reliability performance in North America for transmission systems of 230 kV and above; however, this is a moving target as comparator utilities continue to improve. Our investment plan is designed to improve reliability to remain top quartile. Transmission system capital expenditures for improving reliability are anticipated to be significant over the 2007 - 2009 period, amounting to approximately $2.4 billion. These capital expenditures reflect investment under two broad categories: development and sustainment initiatives.

Development initiatives include transmission reinforcements and additions that allow for the transmission of power from new generation developments within Ontario and from sources of supply in other jurisdictions, to power consumers within Ontario. These projects generally support the Province's policy and direction with respect to issues such as generation development, coal fired generation shutdown, or increased ties to neighbouring transmission systems. In addition, these investments respond to the growing needs for increased power supplies by local communities within Ontario. Our investment plan includes enhancements to the transmission system to accommodate the transfer to market of new supply from nuclear and wind generation, transmission reinforcements in western GTA, Southern Georgian Bay, Woodstock and Midtown Toronto, as well as a new interconnection between Ontario and Québec.

At the local level, we continue to proactively address the supply needs with our customers to meet their load growth. For projects required to provide reliable supply to communities, the participation and support of the affected local distribution utilities as partners in joint planning studies and throughout the consultation and approval processes continues to be essential. Examples of projects initiated to meet the growing needs of our customers include new transmission stations to serve Essex County and Simcoe County, and expansions of transmission stations serving Brampton, Kingston, and Red Lake. In order to meet their future needs, we are in discussions with customers for major transmission expansions and/or new transformer stations in a number of locations including Woodstock, Oshawa and Brampton. Targeted investments in customer delivery point performance, power quality and our 115 kV and 230 kV systems are expected to lead to improved reliability.

Our investment plan also includes increased program expenditures for sustainment initiatives to manage the replacement and refurbishment of our aging transmission infrastructure. Increased emphasis is being placed on those transmission assets that are critical to support generation facilities and the unrestricted transmission of energy to our customers. Through targeted component replacement programs such as gas insulated switchgear, air blast circuit breakers, and

750 MVA autotransformers, improved performance is anticipated, which should reduce transmission outages and system integrity risks.

The timing of many of these projects and others is uncertain as they are dependent upon the IPSP which is expected to be filed in 2007 by the OPA with the OEB for its review and approval, which may take a year, and, in some instances, these projects require approval from various regulatory bodies, as well as negotiations with customers, neighbouring utilities and other stakeholders.

Distribution

Consistent with our approved 2006 distribution rate applications, capital expenditures for the period 2007 - 2009 will focus on new load connections, trouble calls and storm damage, wood pole replacement, and system capability reinforcement. Given the Province's initiatives to encourage renewable energy technologies, we also anticipate increased connection activity which could trigger the need for larger system modifications.

Distribution capital expenditures are focused on improving our aging distribution asset base in order to maintain or improve system reliability. Increasing investments are expected to be made within the distribution business, in particular reflecting increased wood pole replacements, feeder sectionalization and defect management. Across Ontario, we are continuing with the replacement of older distribution systems with higher voltage and more current-standard installations. In addition, we expect to continue to construct new lines and stations in response to system growth forecasts or high load relief requirements, and expect to continue our efforts to make the distribution system more efficient.

In addition, we are moving forward with initiatives to improve the reliability performance of our distribution system. Analysis concerning potential reliability improvement initiatives has revealed that cost-effective improvements can be achieved through improved maintenance practices and through improving the operability of the distribution system by adding sectionalizing capability at strategic locations. We expect to continue with the program started in 2005, ramping up the installation of sectionalizers to completion in 2008.

General

Virtually all of our net income in 2006 was earned from our regulated transmission and distribution businesses, which will remain our principal businesses. We intend to invest in network assets to maintain and reinforce our infrastructure. We expect to focus on our core work programs, making significant investments to improve asset condition, reduce reliability risk and increase customer satisfaction levels.

Financial

We aim to maximize the value of our company while maintaining an effective borrowing capability through stable credit quality and delivering stable financial returns to our shareholder.

We remain committed to understanding and staying abreast of best utility practices in order to execute our business in the most cost effective manner possible.

We believe that cost reductions and productivity improvements can be achieved through the joint management of our transmission and distribution businesses, the Inergi LP outsourcing arrangement pursuant to which we outsourced non-core functions to Inergi LP and the consolidation of our system operations functions. For example, we have consolidated our system operations functions, which were previously dispersed across Ontario, into the OGCC while maintaining a back-up facility in Toronto. This initiative is intended to produce lower costs and better service through the introduction of more technologically sophisticated operating tools.

Annual savings have been achieved in recent years as a consequence of our focus on operational excellence and these savings have largely been re-invested back into our work programs or have offset additional cost pressures. Going forward, we are continuing to focus on capital efficiency and workplace productivity, but additional savings opportunities are fewer, more complex and difficult to achieve.

Employees

We expect to continue to focus initiatives on the retention of key staff and the maintenance and development of the skills and competence of all our employees to manage the impacts of anticipated retirements.

A strategic goal of ours is to manage the demographics of our workforce, an issue which we are monitoring, as the average age of our work force is over 46 years with approximately 19 years of service. In response to this issue, a comprehensive management development program, as well as a succession planning program, has been implemented. See "Risk Factors – Work Force Demographic Risk."

Our Transmission Business

Overview

Our transmission system operates at 500 kV, 230 kV and 115 kV and transmits electricity to customers consisting of 51 local distribution companies, our own distribution businesses and 64 large industrial companies that have loads greater than 5 MW. Electricity is also delivered to utilities in other jurisdictions through inter-ties. Electricity is supplied by generators, both within and outside Ontario, of which 83 in Ontario are connected directly to the transmission grid. Our transmission system serves over four million customers, directly or indirectly, and transported approximately 151 TWh of energy throughout Ontario in 2006. Revenues from our transmission business accounted for approximately 27% our total revenues in 2006 and 30% of our total revenues in each of 2004 and 2005, respectively.

Our transmission system forms an integrated transmission grid that can be divided into two components based on function. The integrated network, or bulk system, operates primarily at 500 kV or 230 kV over relatively long distances and links major sources of generation to transmission stations and larger area load centres. The area supply system operates at 230 kV or 115 kV and links the bulk system to local generators and loads, such as local distribution companies, industrial customers and our own distribution operations. Transformer stations located near load centres step down the high voltage to the level required for retail distribution systems or end-use customers connected directly to our transmission system.

Our transmission system is interconnected with the North American eastern system that is comprised of virtually all of the electric utilities east of the Continental Divide. Our transmission business owns and operates 26 inter-ties at 345 kV, 230 kV, 115 kV and 69 kV levels with New York (9), Québec (9), Michigan (4), Manitoba (3) and Minnesota (1). Due to the nature of the system, the interconnections with Québec are operated in a radial connection mode where load and/or generation is connected to either the Ontario system or the Québec system at any one time, but not to both simultaneously. This mode of operation is also required for one of the Manitoba interconnections. Through these interconnections, we can accommodate imports of about 4,000 MW and exports of approximately 5,800 MW of electricity. In operation, the actual import and export capabilities may be restricted significantly by limitations within our or another jurisdiction's transmission networks, unscheduled power flows between interconnected systems and local load and generation patterns.

Our transmission system is currently relatively free of restrictions in its ability to supply electricity to major load centres from generating sources located across Ontario. A 500 kV system serves as the transmission "backbone" around the GTA with 500 kV connections to Northern Ontario, Ottawa, London and the major generating facilities in Ontario. As new generation projects are assessed in Ontario, the impact on the transmission system will need to be assessed.

Transmission Assets

Our transmission assets can be divided into five functional categories: transmission stations, transmission lines, transmission operations, telecommunication facilities and other transmission assets.

Transmission Stations

Transmission stations are required to integrate the transmission lines into a network and to transform the voltage of the electricity being transmitted, depending on the voltage requirements of the end user. These stations are frequently located at points at which power from two or more transmission lines can be combined and re-routed in different directions. Their main purpose is to transform voltage and, in most cases, to allow switching capabilities between transmission lines. In some instances, facilities with only switching facilities are required. A majority of our switching stations and a few voltage transformation facilities are located at Ontario Power Generation Inc.'s facilities.

Transmission stations can be broadly classified into two categories. The first category consists of terminal stations, including switchyards located at Ontario Power Generation Inc.'s generating facilities, which are used mainly for switching and voltage transformation between the 500 kV, 230 kV, and 115 kV systems. The second category consists of customer supply stations, which are transmission stations that deliver power from the transmission system to wholesale customers. Currently, most transmission stations used for customer supply consist of paired circuits and step-down transformers that are meant to ensure that the failure of any one element will not result in a permanent loss of supply. For smaller or remote loads, a simpler station design with a single transformer or a single circuit is used.

Our transmission system includes 276 transmission stations whose components may include high voltage power transformers, power circuit breakers, high voltage switches, capacitor and reactor banks, protection and control systems, metering and monitoring systems together with site infrastructures such as buildings and security systems.

Transmission Lines

Our transmission lines are classified into bulk power lines and area supply lines. Bulk power transmission lines are main lines delivering power from generating stations or interconnections to receiving terminal stations. Bulk power transmission lines are part of the integrated transmission network and generally operate at 500 kV or 230 kV, with a few at 115 kV. Area supply lines take power from the transmission network at the receiving stations and transmit it to customer supply transformer stations at customer load centres. The usual voltage levels of area supply lines are 230 kV or 115 kV. All of these lines are overhead except for approximately 270 circuit kilometres of underground cables in urban areas.

The transmission system includes approximately 28,600 circuit kilometres of high voltage lines whose major components consist of cables, wood or steel support structures, foundations, insulators, connecting hardware and grounding systems.

Transmission Operations

All of our transmission assets and much of our distribution assets are monitored, controlled and managed from one location, our OGCC in Barrie, Ontario. At the OGCC, the integrity of our transmission and much of our distribution assets are continually monitored in real time to ensure optimal performance of the network under present and potential contingencies and provide immediate response to our customers. The OGCC is fully supported by onsite customer, engineering, facilities, training and process staff. The OGCC also coordinates our extensive outage program with the various internal stakeholders and our external customers. Required outages are assessed and coordinated to minimize their impact on system security and reliability. In addition to the OGCC, there is a fully functional back-up facility located in Toronto. The back-up facility would be staffed in the event of an evacuation of the OGCC. The IESO manages the electricity marketplace and directs the operation of Ontario's integrated transmission network. Since we own and operate the largest portion of this transmission network, we have the responsibility to ensure that the direction from the IESO is safe and optimizes our asset performance and our connection performance to our customers. Accordingly, the OGCC reviews, approves, performs and/or authorizes all switching and control actions of our transmission system assets when directed by the IESO and, independently, when required to ensure public/employee safety and to maintain integrity of our assets and our connected customers.

Telecommunications Facilities

Our requirements for telecommunications include services for administrative data, voice and power system protection and operation. These requirements are met through the use of a wide range of our own facilities and services acquired from other telecommunications service providers. The reliability and availability of telecommunication services used in the protection and operation of our transmission system are vital to meeting our interconnection obligations, ensuring the protection of our assets and ensuring the reliability of our transmission system. Historically, if telecommunications service providers were not able or willing to provide the required services at an appropriate cost, we installed our own telecommunication facilities.

These owned facilities include analogue microwave radio, fibre optic cable, power line carrier and mobile radio systems. The analogue microwave radio system is nearing the end of its useful life and we are continuing its replacement with digital fibre-optic and digital microwave system. Replacement is expected to be completed in 2007.

Other Transmission Assets

Other assets include those supporting the ongoing maintenance and operation of the transmission system, such as office and service buildings, transportation and work equipment and other office and information technology assets.

Projects Relating to Interconnection Capacity

Québec

Construction began in December 2006 on a new inter-tie with the Province of Québec that would increase our inter-tie capacity by approximately 1,250 MW. This consists of a new two-circuit 230 kV line between the systems near Ottawa, along with AC-DC-AC conversion facilities in Québec needed to connect the two systems in a continuous manner (currently, load or generation is required to be isolated to either system for import or export). We expect the new inter-tie to come into service in the spring of 2009.

Michigan

Two of our inter-ties with the State of Michigan have been upgraded with the installation of two, three phase shifting transformers and an autotransformer. The phase shifters were put into operation during emergency situations in 2005 and have been tested weekly since the fall of 2005. Full operation is pending completion of an interconnection agreement with the International Transmission Company in Michigan, which is the utility to which we are connected by these inter-ties. This equipment is intended to provide us with greater control over the use of our Michigan interconnection so as to better control transactions directly across the Ontario-Michigan border and indirectly across the Ontario-New York border. As a result, we expect to increase our export capacity by 1,000 MW and our import capacity by 500 MW.

Manitoba

Hydro One and Manitoba Hydro have supported the continuing efforts by the Ontario and Manitoba governments in the development of the next steps for a Clean Energy Transfer Initiative. A Memorandum of Understanding was signed by the two governments on October 27, 2005 addressing the process to negotiate potential short and long-term agreements for power purchases by Ontario from Manitoba and the development of associated transmission facilities.

Hydro One and Manitoba Hydro have completed studies and a report on the transmission upgrade. At present, work on both the shorter-term upgrade and a potential longer term deal and development of a new 1,500 MW high capacity tie is now on hold pending further direction from the Province or the OPA. We estimate that the earliest in-service date of this project is 2014. Bringing electricity supply from the northern region of Manitoba represents an extensive and complex undertaking involving many parties.

NERC (North American Electric Reliability Council) / NPCC (Northeast Power Coordinating Council)

In North America, standards to improve the reliability and security of the interconnected bulk electric system are developed by NERC. The United States' Energy Policy Act of 2005 mandated compliance with these standards and assigned the Federal Energy Regulatory Commission ("FERC") as the regulatory agency that will approve and enforce these standards in the United States. Subsequently, FERC has approved establishment of NERC as an Electric Reliability Organization ("ERO"), with responsibility for developing reliability standards, monitoring compliance, assessing non-compliance, and applying sanctions for non-compliance.

The Market Rules mandate that we comply with the reliability standards established by NERC and NPCC and our transmission licence mandates that we comply with the Market Rules.

NERC Readiness Audit

NERC performed a Readiness Audit (the "Audit") on our OGCC during the week of June 26-29, 2006. The NERC Readiness Audit Program independently reviews the operation of registered operators of bulk power systems in North America and determines their readiness to maintain safe and reliable operations. The Audit is designed to ensure that operators of the bulk electric system have the tools, processes and procedures in place to operate reliably. NERC uses the results of these Audits to champion the changes required to improve reliability performance of these entities.

Hydro One's transmission operations facilities, processes and staff received high marks for their ability to reliably operate and maintain Ontario's electricity transmission system. The Audit results indicated: two examples of excellence, eight positive observations and five recommendations. The examples of excellence centered on OGCC's sophisticated interactive voice communication system and the extensive physical security protocol, infrastructure and procedures. The positive observations were as follows:

- Strong commitment to 100% NERC operator certification at the reliability coordinator level
- Safety elevated to a level of critical importance in all elements of operation
- Effective utilization of simulator to enhance controller training
- Intranet site to enhance training resource availability and use
- Well integrated Network Management System providing easy access to all required tools and documents
- Carefully designed, fully equipped backup centre
- Communications hub with around the clock staffing and support
- Impressive audit preparation

The Audit results recommended that Hydro One implement changes and enhancements to Hydro One's training program; maintain the current high-priority Hydro One controller NERC-certification process; review and revise interconnection agreements that predate NERC standards and/or the current Transmission System Code; complete the document management system upgrade regarding policies and procedures; and review and revise the backup control center implementation plan to consider transportation requirements for all expected scenarios.

Hydro One is moving forward in addressing all of these recommendations. Hydro One has applied to NERC and received accreditation as a NERC certified training provider, altered some training curriculum and is in the process of updating some interconnection agreements. Hydro One met the NERC requirement that the OGCC's controllers be NERC certified in 2006. During 2006, other non-controller staff at OGCC have received NERC Certification and this is expected to continue in 2007.

IESO

On September 22, 2006, Ontario Regulation 452/06, made under the Electricity Act, 1998 came into force. The regulation provided that one of the objects of the IESO was to establish and enforce standards and criteria relating to the reliability of transmission systems.

Our Distribution Business

Overview

Our distribution system provides customers with electricity distribution services through a low voltage distribution network. During 2006, approximately 29.0 TWh of electricity were delivered through the distribution system to approximately 1.3 million customers located in rural and urban areas (including approximately 120,000 urban retail customers located in Brampton, Ontario). The distribution system also serves 34 local distribution companies that are not connected directly to our transmission system, another 35 local distribution companies that are connected to our transmission system and 48 customers with loads exceeding 5 MW. The distribution system comprises approximately 124,700 circuit kilometres of lines, including phase multipliers, operating mainly at voltages of 50 kV or less and we own 1024 distribution and regulating stations together with one transmission station. Our distribution system distributes electricity from our transmission system and 104 small embedded generators. Unlike the systems found in densely populated areas that are designed to include built-in redundancy, our distribution system supplies mainly rural areas with low population densities. To provide a cost effective service to these areas, the distribution system is configured as a largely radial system, meaning that it is configured in straight lines, rather than loops, so that an outage at any point along the line causes all customers further down the line to lose power. As a result, component failures require immediate repair or replacement prior to service restoration. Revenues from our distribution business accounted for approximately 70% and approximately 72% of our total revenues in 2005 and 2006, respectively.

Distribution Assets

The electricity distribution system is made up of three components: (i) low voltage lines connecting our transmission stations to our distribution stations and to some industrial customers and local distribution companies; (ii) distribution and regulating stations; and (iii) our distribution lines connecting the low voltage side of the distribution stations to industrial, commercial, farm, and residential customers as well as embedded local distribution companies. The three components include equipment such as poles, conductors, transformers, reclosers, protection devices and switches. Other assets include service centres and equipment, such as our transportation fleet, computing equipment and service and construction equipment.

Remote Communities

Through our subsidiary, Hydro One Remote Communities Inc., we operate 18 regulated generation and distribution systems across Northern Ontario which serve 20 remote communities that are not connected to Ontario's electricity grid, the facilities of which are owned either by us or by OEFC. These remote communities include a total of approximately 3,400 customers. Electricity used by these remote communities is produced by 57 installed diesel generators owned by us, which are supplemented by small amounts of wind or hydroelectric generation. Pursuant to Regulation 199/02 under the *Electricity Act, 1998* as later amended by Regulation 454/03, we are required, through one or more of our subsidiaries, to operate and maintain existing generation and distribution assets in, and supply electricity to, these remote communities.

Our Telecommunications Business

Our telecommunications business, which is carried on by our subsidiary, Hydro One Telecom Inc., markets dark and lit fibre optic capacity to telecommunications carriers and commercial customers with broadband network requirements. This business also markets co-location space on Hydro One Networks Inc.'s microwave towers to wireless service providers.

Employees

At the end of 2006, our Hydro One Networks Inc. subsidiary had 4,018 regular (i.e., permanent) employees comprised of 469 non-represented executive and managerial staff, 2,862 employees represented by the Power Workers' Union and 687 employees represented by the Society of Energy Professionals. In addition, our Hydro One Brampton Networks Inc. subsidiary had 43 non-represented regular staff, 101 employees represented by the Canadian Auto Workers and 41 employees represented by the International Brotherhood of Electrical Workers. We also had 1,283 non-regular (i.e., temporary) employees comprised of 7 executive and managerial staff, 633 employees represented by the Power Workers' Union, 45 employees represented by the Society of Energy Professionals and 598 employees represented by a combination of the Canadian Union of Skilled Workers (an electrical trade union) and the 16 construction building trade unions that have collective agreements with the Electrical Power Sector Construction Association. Hydro One Inc., Hydro One Remote Communities Inc. and Hydro One Telecom Inc. together have approximately 104 employees in total.

In 2005, we negotiated a three-year collective agreement with the Power Workers' Union ("PWU") which will end on March 31, 2008 and through arbitration reached a three-year agreement with the Society of Energy Professionals ("Society") which expires on March 31, 2008. The substantial majority of our employees are represented either by the PWU or Society. Furthermore, in 2005, we negotiated three-year agreements with the Canadian Auto Workers and the International Brotherhood of Electrical Workers in Brampton, both of which expire on March

31, 2008 and a three-year agreement with the Canadian Union of Skilled Workers which expires on April 30, 2008. See "Risk Factors – Labour Relations Risk."

Outsourcing Arrangement with Inergi LP

Through our subsidiary Hydro One Networks Inc. we entered into an outsourcing services agreement with Inergi LP as of December 28, 2001. The provision of services by Inergi LP commenced on March 1, 2002. Inergi LP is an affiliate of CapGemini Canada Inc. Under the agreement, Inergi LP provides us with customer service operations and settlements, as well as supply management services, pay operations services, enterprise technology and finance and accounting services. As part of the agreement with Inergi LP, 906 of our unionized and non-unionized employees (including 770 regular and 136 non-regular employees) were transferred to Inergi LP on March 1, 2002. Under the agreement, we continue to make available, for use by the transferred employees, the assets used by them prior to the transfer of their employment, with refurbishments as needed.

The agreement has a 10-year term and has base service fees of approximately $1 billion over the term of the agreement. Fees are subject to decreases based on optional external benchmarking analyses every three years. Cap Gemini Ernst & Young US LLC has provided a financial guarantee, as well as a performance guarantee, of the obligations of Inergi LP. The performance guarantee covers the transition period in the event that the agreement is terminated. The agreement provides for rights of termination for each of the parties, including, on the part of our company, rights of early termination for convenience and upon the occurrence of specified business events. In such cases, we are obliged under the agreement to pay specified termination fees, as well as to contribute to resulting severance and other costs. In addition, upon expiration of the agreement, we have an obligation to contribute to employee severance costs, if any, up to a maximum amount of $10 million. See "Risk Factor – Risks Associated with Outsourcing Arrangement."

Pension Plan

We established a defined benefit registered pension plan on December 31, 1999. Hydro One Inc. manages and invests the assets and liabilities of the pension fund as plan sponsor and administrator of the plan. As of December 31, 2006, there were 4,060 active members and 7,620 pensioners and disabled and deferred members. We are required to file a new actuarial valuation as at December 31, 2006 with the Financial Services Commission of Ontario on or before September 30, 2007. See "Risk Factors – Pension Plan Risk."

Effective December 31, 1999, we established the Hydro One Inc. Supplementary Pension Plan to provide supplementary pension benefits. On October 30, 2001, this plan was amended to require the establishment of a trust for the purpose of creating security for payment of the supplementary pension benefits provided for therein. This trust was constituted as a Retirement Compensation Arrangement under the provisions of the *Income Tax Act* (Canada), and security was issued in the form of a letter of credit.

Insurance

We maintain insurance coverage, including liability, all risk property and boiler and machinery insurance. We also maintain other insurance coverage that is required by provincial statute, which covers automobile liability, pesticide liability and aircraft liability. We do not have insurance for damage to our transmission and distribution wires, poles and towers located outside our transmission and distribution stations including damage caused by severe weather, other natural disasters or catastrophic events or for environmental remediation costs. See "Risk Factors – Risk of Natural and Other Unexpected Occurrences."

Environmental

Although primarily regulated at the provincial level, jurisdiction over the environment is shared by Canadian federal, provincial and local governments. As a result, we are subject to extensive federal, provincial and local regulation relating to the protection of the environment that governs, among other things, environmental assessments, discharges to water and land and the generation, storage, transportation, disposal and release of various hazardous substances. See "Risk Factors – Environmental Risk."

Environmental Management System

We have an environmental management system designed to identify environmental effects of our operations and facilities and to aid in the continual improvement of our environmental performance. We continually update our environmental management system to reflect organizational changes and progress in achieving our environmental goals.

Permits, Licences and Approvals

We are required to obtain and maintain specified permits and approvals from federal, provincial and local authorities that relate to, among other things, waste disposal, drainage works and discharges to air and water.

A number of electricity projects we undertake or propose may require environmental approvals from the federal government or the use of federal lands, including reserves and other lands subject to the *Indian Act* (Canada), and will be subject to federal environmental assessment. Additional interconnection facilities with neighbouring utilities in other provinces and states require approvals and will be subject to federal regulatory review, which may include environmental assessment. Certain projects will also be subject to the provincial environmental assessment process. A significant number of our existing projects are subject to a streamlined environmental assessment process. The scope, timing and cost of environmental assessments at either the federal or provincial level depend on the type of project and its potential for environmental impact.

Releases

Federal, provincial and municipal environmental legislation operates to regulate the release of substances into the environment through the prohibition of discharges that will or may have an adverse effect on the environment. Spills and leaks of substances occur in the course of our normal operations. We could incur fines or clean-up costs in connection with these releases. Accordingly, we have spill, leak prevention and leak mitigation programs involving the testing, replacement, repair and installation of containment systems including regasketting of transformers and sulphur-hexafluoride filled equipment. In addition, we have an emergency response capability which we believe is sufficient to minimize the environmental impact of spills and to comply with our legal obligations.

Hazardous Substances

We manage a number of hazardous substances, such as polychlorinated biphenyls ("PCBs"), herbicides and wood preservatives. In addition, some facilities have substances present which are designated for special treatment under occupational health and safety legislation such as asbestos, lead and mercury. We have environmental management programs in place to deal with PCBs and herbicides.

We continually remove PCB-contaminated materials from service and send PCB waste for decontamination or destruction. All high voltage electrical equipment containing PCBs at concentrations greater than 10,000 parts per million has been removed from service. Some equipment containing PCB-contaminated mineral oil continues to be in service, including an estimated 18,000 distribution transformers, as well as small electrical equipment components at transmission stations. PCB-contaminated mineral oil in small transmission equipment components is tested and retro filled as part of station refurbishment programs.

On November 4, 2006, Environment Canada published new draft regulations governing the management of polychlorinated biphenyls (PCBs). It is expected that these draft regulations will be finalized later in 2007. We have estimated the non-capital expenditures required to comply with these draft regulations to be between $250 million and $375 million. If required, most of these additional expenditures would be incurred in the 2013 to 2025 period.

We use herbicides primarily for the control of incompatible vegetation on rights-of-way, along distribution lines and on station sites. We currently use an integrated management approach toward vegetation management using manual and mechanical cutting, together with the selective use of herbicides. Herbicides are applied in accordance with the *Pesticides Act*. As indicated below, the historical use of a herbicide has contaminated some of our properties and some nearby properties.

Wood preservatives are used in wood poles to protect the wood against fungi and insects and thereby extend their service lives. In the past, we have used poles which were impregnated with pentachlorophenol. We respond to contamination problems related to pentachlorophenol migration as they arise.

Land Assessment and Remediation

We have developed a voluntary land assessment and remediation program in order to identify and, where necessary, remediate contamination related to our transmission and distribution stations, service centres and remote generating stations. It involves the systematic identification of any contamination at or from these facilities and, where necessary the development of remediation plans for Hydro One and adjacent private properties. Potential contaminants include insulating oils, substances previously used for vegetation control such as arsenic trioxide, fuel oil, gasoline, PCBs and wood preservatives such as pentachlorophenol. Phase I assessments have been completed for most of the transmission stations, service centres and remote generating stations. Limited Phase I assessments were undertaken at distribution stations given their large number and similar operating history. Site screening involving on-site soil sampling at the areas of greatest potential for contamination have been undertaken at the majority of these sites.

The inventory of land in the program is approximately 1,562 sites. The number of sites where at least one soil or groundwater sample on site was found to be above Ministry of the Environment standards (of at least one substance of concern) is 672. We have completed the clean-up of 127 sites, which include sites where underground fuel dispensing/storage tanks were removed. Further work may be required in the event we sell or decommission any of these sites. We have developed a risk-based property ranking system to assist in establishing priorities for Phase II sampling. This system is supplemented with visual inspections of the sites and nearby receptors. Remediation and/or risk management is occurring based on Phase II results and discussions with affected property owners and regulatory authorities. The Ministry of the Environment (at the local and head office level) and local Health Departments/Medical Officers of Health are actively involved in the program.

Future costs related to the land assessment and remediation program are currently estimated at approximately $44.5 million over the next nine years. The estimated expenditure for 2007 is approximately $11.4 million.

Electric and Magnetic Fields

Electric and magnetic fields exist wherever electricity is used or transmitted, including electric power facilities such as transmission and distribution lines and substations, and within every building in Ontario that has electrical service. Based on current research, the consensus of the scientific community is that a public health risk from exposure to electric and magnetic fields has not been established. This is reflected in Health Canada's statement that typical exposures to electric and magnetic fields present no known health risks. We sponsor research and monitor national and international developments. Electric and magnetic fields are not currently regulated by either the federal or provincial governments and we are not aware of any current plans to regulate electric and magnetic fields.

Legal Proceedings

In connection with the reorganization of Ontario Hydro, we have succeeded Ontario Hydro as a party to various pending legal proceedings relating to the businesses, assets, real estate and employees transferred to us. We will also assume responsibility for future claims relating to the businesses, assets, real estate and employees acquired by us and arising out of events occurring prior to, as well as after, April 1, 1999. In addition to claims assumed by us, we are, from time to time, named as a defendant in legal actions arising in the normal course of business. The pending legal proceedings, which include material claims to which we are currently a defendant, are discussed below.

On September 1, 1995, Torcom Communications Inc. named Ontario Hydro as one of several defendants in a suit in the Ontario Superior Court of Justice seeking damages of $150 million, as well as specific performance of agreements and interim injunctive relief. On October 31, 2006, this action against all the defendants was dismissed without costs.

On March 29, 1999 the Whitesand First Nation Band commenced an action in the Ontario Superior Court of Justice, naming as defendants the Province, the Attorney General of Canada, Ontario Hydro, OEFC, Ontario Power Generation Inc. and our company. On May 24, 2001, the Whitesand First Nation Band issued an almost identical claim against the same parties. The reason for the second claim is the procedural defence of the Province that proper notice of the first claim was not given under the *Proceedings Against the Crown Act* (Ontario). These actions seek declaratory relief, injunctive relief and damages in an unspecified amount. The Whitesand Band alleges that since at least the first half of the twentieth century, Ontario Hydro has erected dams, generating stations, electrical power lines and other facilities within or affecting the band's traditional lands and that those facilities have caused damage to band members and the lands, including substantial flooding and erosion. The Whitesand Band also claims treaty rights to a share of the profits arising from the activities of these Ontario Hydro facilities, an entitlement to increases in annuity payments established by treaty and for breach of an alleged contract to reimburse the Band for negotiation costs with Ontario Hydro. The Whitesand Band asserts multiple causes of action, including trespass, breach of fiduciary duty, nuisance and negligence. The May 24, 2001 case was consolidated in 2004 with a similar claim by Red Rock First Nation Band which commenced on September 7, 2001, as all procedural issues in both matters were the same. There is now one action in which the claims of both Whitesand and Red Rock are set out. The claims relating to activities of Ontario Hydro (i.e., flooding) are matters for which Ontario Power Generation Inc. would have responsibility pursuant to transfer orders under the *Electricity Act, 1998*. In the consolidated claim, Whitesand and Red Rock seek to tie Hydro One into the flooding allegations on the alleged basis of the integrated nature of the transmission system with the entire electricity system, which includes the method of generating power. To date, Hydro One has not filed a defence. Hydro One believes that it is unlikely that the outcome of this litigation will have a material adverse effect on our business, results of operations, financial position or prospects.

Health and Safety

Hydro One considers health and safety to be of paramount importance in the operation of its business and continues to maintain first quartile performance in key areas as well as to develop, implement and maintain progressive programs and initiatives. We are committed to creating and maintaining an injury-free workplace with concentrated focus on the elimination of serious injuries or close calls which have the potential to cause serious injuries. We are developing a number of programs and initiatives for accident prevention and to minimize the risk of injury to the public associated with our facilities and operations. Policies are in place for both employee health and safety and public safety.

Corporate safety performance indicators and targets have been developed to measure serious incidents, especially those involving high energy levels that have the potential to cause fatalities and very serious injuries. In addition, measures are in place to monitor the days lost as a result of a workplace injury. These indicators are monitored by management and by the Health and Safety Committee of the Board of Directors. Employee compensation is tied, in part, to success in achieving annual safety performance targets. An effective early and safe return to work process has allowed us to ensure that, when injuries occur, employees recover and return to the workplace as soon as possible.

Several programs and practices have been implemented to improve our safety performance. Actions currently underway include training programs and support for young workers, including apprentices, preserving core competencies through supervisory selection and reviewing/updating supervisory programs, improving the contracting process to provide for clear and consistent standards for work performance, and better understanding of the human decision-making process to improve performance. Work site inspections and a safety rotation/mentoring program involving the major lines of business are also contributing to a safer workplace by identifying hazards, ensuring that proper barriers are in place before work is undertaken, as well as supporting the development and maintenance of a strong safety culture. Our incident investigation process allows us to learn as much as possible from incidents in order to develop improvements to job planning and prevent recurrences.

Hydro One has integrated the management of health and safety into a single health, safety and environment management system. Effective risk assessment and management are key elements to the successful minimization of risk and safety performance improvement. Within the organization, hazards have been identified and controls implemented to mitigate these risks.

The Auditor General of Ontario and its 2006 Annual Report

The mandate of the Office of the Auditor General of Ontario ("AG") was expanded to include conducting audits of entities such as Hydro One as a result of amendments to Ontario's *Auditor General Act* which came into effect on November 11, 2004. The 2006 Annual Report of the Office of the Auditor General of Ontario (the "Report") was tabled in the Legislative Assembly of Ontario on December 5, 2006. Section 3.07 of the Report contains the results of the first value-for-money audit conducted at Hydro One under the AG's expanded mandate. The audit pertained to the year 2005 and the controls impacted were primarily operational in nature. The AG found that Hydro One had adequate policies in place to ensure that goods and services were acquired with due regard for value for money. However, they did note that systems and procedures were not adequate to ensure compliance with corporate policies. Findings and recommendations focused on the areas of blanket purchase orders, sole-source procurement, procurement of consultants and contract staff, completeness of documentation in procurement files, business process outsourcing contract management, and the use of corporate charge cards, including cheque writing. Prior to the audit, management had been in the process of implementing various policies and procedures to strengthen controls and address previous internal audit findings in the areas examined. These actions are now complete and address many of the concerns and recommendations identified by the AG. All AG recommendations have now been implemented.

REGULATION

The Statutory and Operating Framework

General

The *Electricity Act, 1998* and the *Ontario Energy Board Act, 1998*, as amended from time to time, primarily establish the broad legislative framework for Ontario's competitive electricity market. The *Electricity Act, 1998* implemented the fundamental principles of the restructuring of Ontario's electricity industry, enabling the implementation of open non-discriminatory access to transmission and distribution systems. The *Ontario Energy Board Act, 1998* expanded the jurisdiction and mandate of the OEB to include regulation of the electricity and natural gas markets. Both statutes have been amended several times, as discussed in the sections below.[1]

Since May 1, 2002, the date of Open Access, the prices of electricity in Ontario began to be determined by market forces in the wholesale electricity market administered by the IESO. The IESO is the centralized independent electricity system co-ordinator responsible for maintaining the security and reliability of electricity supply in Ontario and for directing the operations of the IESO controlled grid. The IESO itself is licensed by the OEB and funded through fees which are approved by the OEB and levied on all market participants. See "Regulation – Contractual Arrangements, Codes and Licences – Operating Agreement with the IESO."

Market participants may buy and sell electricity from the wholesale spot markets, administered by the IESO. Alternatively, they may contract such transactions with each other, albeit with the obligation to schedule these transactions with the IESO.

Electricity consumers in the retail market also have a choice of suppliers. They may contract with any retailer of their choice or they may continue to be provided with standard supply service by their incumbent distributor. In either case, the distributor is obliged to continue to deliver electricity to them as long as they are connected to that distribution system. See "Regulation – Contractual Arrangements, Codes and Licences – Electricity Industry Codes."

Each distributor, including our company, continues to have an obligation to connect and supply customers in accordance with the *Electricity Act, 1998* and the conditions of its distribution licence and rate orders. On May 1, 2002, we began to provide customers connected to our distribution system who did not choose a competitive retailer (our standard supply customers) with electricity in accordance with the provisions of the OEB's Standard Supply Service Code and the Regulated Price Plan, where applicable. See "Regulation – Contractual Arrangements, Codes and Licences – Electricity Industry Codes."

In May 2005, the OEB completed a consultation and review process which culminated in the issuing of the 2006 Electricity Distribution Rate Handbook. This handbook provided the framework for the OEB's review of electric distribution utilities' revenue requirements so that rates may be re-established based on this historical average or forecasted need for implementation by May 1, 2006. See "Regulation – Rate Orders and Related Issues for Hydro One's Businesses – Distribution – Current Rate Orders and Distribution Rate Structure" and "Regulation – Rate Orders and Related Issues for Hydro One's Businesses – Distribution – Rate Orders for Remote Communities." Cost allocation issues are being addressed by a working group which began work in September, 2005. They had a filing model available in the fall of 2006, enabling distributors to subsequently file new cost allocation studies in 2007.

In addition, legislative changes created the OPA, an independent, non-profit corporation which is mandated to:

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[1] Amending statutes include: *Reliable Energy and Consumer Protection Act, 2002 Electricity Pricing, Conservation and Supply Act, 2002, Ontario Energy Board Amendment Act (Electricity Pricing), 2003, Electricity Restructuring Act, 2004 and Ontario Energy Board Consumer Protection and Governance Act, 2003* and the *Energy Conservation Responsibility Act, 2006.*

- assess the adequacy and reliability of electricity resources for the medium and long term;
- forecast future electricity demand and potential for conservation and renewable energy;
- prepare an integrated system plan for generation, transmission and conservation;
- lead the planning and co-ordination of electricity conservation measures through a Conservation Bureau;
- procure new supply, and initiate the development of transmission and demand management programs by competition or by contract; and
- assist the Province in achieving alternative and renewable energy goals.

The OPA has powers to raise funds, including borrowing from the Province, and is expected to be self-financed through fees approved by the OEB. Each director of the OPA holds office as an independent director and not as a representative of any class of persons in the industry.

On July 13, 2006 the Ministry of Energy issued a directive to the OPA regarding the Ministry's decision to have the OPA assume responsibility for organizing the delivery and funding of CDM programs through distributors in Ontario. See "General Development of the Business – Conservation and Demand Management."

The role of the IESO also changed. The IESO relinquished responsibilities for medium and long-term forecasting to the OPA and for market surveillance to the OEB. Through its billing and settlement systems, the IESO is required to ensure that, over time, participants pay the true cost of electricity. It retains authority over the:

- operation of the wholesale system and the operation and reliability of the power system;
- short-term forecasting; and
- ensuring compliance with the market rules.

In its enhanced role, the OEB is responsible for:

- promoting economic efficiency and cost effectiveness in electricity generation, transmission and distribution and demand management;
- reviewing and approving the OPA's IPSP and procurement processes;
- regulating payments to generators of regulated facilities; and
- regulating all elements of electricity price, including generation, for low volume and designated consumers.

The role of electricity distributors has also been expanded to permit the undertaking of energy management. The legislation has been amended to promote the expansion of electricity supply and capacity, facilitate load and demand management, encourage conservation and efficiency and regulate prices in parts of the electricity sector. The key features of the legislative amendments which affect Hydro One's businesses, include:

- the continuation of a wholesale market structure for the purchase and sale of electricity in Ontario;
- withdrawal of the requirement for prior Ministerial approval of distribution rate applications to the OEB; and
- explicit authority of the Minister of Energy to set targets for conservation and renewable energy and guidelines for supply diversity.

Changes also arise from the *Energy Conservation Responsibility Act, 2006* which received Royal Assent on March 28, 2006. This provides the framework for the installation of smart meters in all Ontario homes and small businesses by the end of 2010. Under the legislation, a new entity will oversee the communications systems and technologies, collect and manage data, and may facilitate meter procurement. Distributors will own, install, operate and maintain the meters. See "General Development of the Business – Smart Meters."

Contractual Arrangements, Codes and Licences

Operating Agreement with the IESO

Under the *Electricity Act, 1998*, the IESO is required to enter into agreements with transmitters giving it the authority to direct the operations of the transmitters' systems. On June 8, 2001, we signed our 10 year operating agreement with the IESO, which sets out the specific responsibilities of both parties relating to the provision of transmission service. The agreement, among other things, identifies our facilities that will be included in the IESO controlled grid; provides that the IESO will direct the operation of the facilities of our subsidiary, Hydro One Networks Inc.; defines the respective obligations of Hydro One Networks Inc. and the IESO regarding the operation of these facilities; provides for co-ordination between Hydro One Networks Inc. and the IESO of modifications or additions to our transmission facilities; establishes the terms and conditions relating to information sharing and confidentiality, monitoring and telecommunications facilities, and the delineation of accountabilities for protection systems; and addresses issues of liability and indemnification obligations.

By contrast, the distribution portion of Ontario's network is not directed by the IESO and remains subject to the operational control of local distribution companies in accordance with the regulatory framework.

Hydro One's Relationships with Other Market Participants

Generators, local distribution companies and customers directly connected to our transmission system must enter into agreements with us to ensure reliable connection service in conformity with the Transmission System Code established by the OEB.

Some market participants, such as generators and large load customers embedded within distribution systems, are connected to the wholesale market through lines and facilities that are defined as "distribution" and owned by local distribution companies. At a minimum, under the *Electricity Act, 1998*, local distribution companies must provide non discriminatory access for eligible generators and customers to the wholesale markets administered by the IESO. The local distribution companies must advise the IESO of any conditions in their distribution system that may affect the ability of embedded generators and loads to participate in the broader IESO administered markets.

Electricity Industry Codes

The OEB has approved the Affiliate Relationships Code for Electricity Distributors and Transmitters, the Standard Supply Service Code, the Transmission System Code, the Distribution System Code, the Retail Settlement Code and the Electricity Retailer Code of Conduct. These Codes and requirements prescribe minimum standards of conduct and standards of service for transmitters, distributors and retailers in the electricity market.

The Affiliate Relationships Code for Electricity Distributors and Transmitters establishes the standards and conditions for the interaction between electricity distributors or transmitters and their affiliated companies. Accordingly, our subsidiaries through which we transmit and distribute electricity are subject to this Code. Among its primary purposes, this Code is intended to minimize the potential for a distributor or transmitter to cross subsidize competitive or non monopoly activities.

The Standard Supply Service Code governs the conduct of distributors, including our company, in their provision of standard supply service. Under the Code, a distributor's rates for standard supply service are approved and fixed by the OEB and consist of the price for electricity and an administrative charge which is intended to allow the distributor to cover its costs of providing the service. Our rates for standard supply service were approved by the OEB. As a result of the legislative changes, on April 1, 2005, our prices for standard supply service moved from regulated levels to the levels set in the RPP. On June 16, 2005, a revised Standard Supply Service Code was issued to accommodate these changes. See "Regulation – Rate Orders and Related Issues for Hydro One's Businesses." Each of the Transmission System Code and the Distribution System Code sets the minimum conditions that a transmitter or distributor, respectively, must meet in carrying out its obligations to transmit or distribute electricity.

The Transmission System Code applies to all transactions and interactions between a transmitter and distributors, generators and consumers of electricity directly connected to the transmission system. On August 20, 2005, the OEB completed a three-year review of the Transmission System Code and related matters, following which it issued a revised Transmission System Code. This revised Transmission System Code implements the OEB's June 2004 decision on principles governing issues relating to transmission system by-pass, available capacity, cost responsibility, economic evaluation and contestability. This decision allows customers to build new connections that Hydro One would otherwise have owned and operated. Compensation to Hydro One for acquired or by-passed assets is limited to the asset's net book value. However, existing generation cannot re-connect to cause by-pass of transmission tariffs (as this does not support new generation facilities in the Province). The decision also accepts that rates may be increased as a result of such by-pass. Hydro One has undertaken initiatives and a compliance assessment process which reflects the Transmission System Code changes. In accordance with the revised Transmission System Code, Hydro One filed a final version of its revised connection procedures on August 20, 2006.

The Distribution System Code applies to all transactions and interactions between a distributor and all retailers, generators, distributors, transmitters and electricity consumers who use the distributor's distribution system. Following a consultation with stakeholders in 2003, the OEB amended the Distribution System Code to clarify and streamline the process and requirements for connections, with changes coming into effect in March 2004. The OEB also amended the Distribution System Code to include requirements for electricity consumer security deposits to ensure consistent and equitable treatment across distributors, coming into effect in July 2004. The Distribution System Code was further revised to include an obligation on distributors to provide customers with standard safety information upon disconnection. During 2005, the OEB undertook three amendments to the Distribution System Code. These changes were required to accommodate the Ministry of Energy's standard offer program (a program to promote small generators using clean or renewable resources that are embedded in distribution systems) in concert with the OPA's initiative in this area. The intent was to address net metering as required for eligible generators and to ensure clarity and uniformity in its processes related to connections and expansions. In 2006, the OEB introduced amendments to the Distribution System Code pertaining to new connections and expansions. The changes are intended to improve the transparency of how connection costs are factored into economic evaluations for expansions and clarify the rules for a more consistent approach among distributors.

The Retail Settlement Code outlines the obligations of a distributor with respect to its relationships with other retail market participants and its role as retail market settlements administrator. The Retail Settlement Code is supported by the Electricity Distribution Rate Handbook to ensure that, subject to credit risk, distributors will not make or lose money in undertaking retail market settlements. In particular, the distributors served by our company's distribution system may have the option of receiving electricity from us rather than purchasing from the wholesale market participants. In this event, we would require increased working capital to cover accounts receivable and increased ongoing costs and would expect to recover these costs through our distribution rate order. On April 1, 2005, a revised Retail Settlement Code was issued to reflect the changes required by the RPP structure. See "Regulation – Rate Orders and Related Issues for Hydro One's Businesses."

The Electricity Retailer Code of Conduct sets the minimum standards under which a licensed electricity retailer may retail electricity. Specific requirements may apply for offers made to residential or small business consumers.

Electricity Industry Licences

During 2003, the OEB undertook a review of the licences of all electricity transmitters, distributors and generators in Ontario. The new licences have a 20-year term and incorporate the reporting and record-keeping requirements in accordance with the OEB's Electricity Reporting and Record Keeping Requirements. New licences for all of our regulated businesses were issued in 2004.

Transmission Licence

The following are the key conditions of our transmission licence:

- ***Obligation to Enter into Agreement with the IESO*** – We are required to enter into the operating agreement with the IESO, providing for the IESO's direction of the operation of our transmission system. On June 8, 2001, we signed our operating agreement with the IESO. See "Regulation – Contractual Arrangements, Codes and Licences – Operating Agreement with the IESO."

- ***Non-discriminatory Access*** – If a generator, distributor, retailer, wholesaler or customer requests that we convey electricity using our transmission system, subject to capacity constraints, we must make an offer to convey electricity on behalf of the applicant consistent with the applicable Market Rules and the Transmission System Code.

- ***Obligation to Connect*** – We may not refuse an offer to connect to our transmission system which has been made in accordance with the terms of our transmission rate order, the Market Rules and the Transmission System Code unless we are permitted to do so by the OEB, the legislation or any codes, standards or rules with which we are obligated to comply as a condition of our licence. We must respond to a request for connection within 30 business days in compliance with published connection procedures.

- ***Obligation to Maintain System Integrity*** – We must maintain our transmission system to the standards established in our agreement with the IESO, the Market Rules and any other recognized industry operating or planning standard which has been specified by the OEB.

- ***Transmission Rates*** – We may not impose charges for the transmission of electricity or connection to our transmission system except in accordance with our transmission rate order.

- ***Separation of Business Activity*** – Our transmission business must separate its financial records from those of any other business of Hydro One.

- ***Expansion of the Transmission System*** – We may not construct, expand or reinforce our transmission system or make an interconnection except in accordance with the legislation, regulations, Transmission System Code and the Market Rules. The OEB may require us to expand or reinforce our transmission system if it determines that there is a threat to security, reliability or integrity of the system. We were required to and did make our best efforts to expand our inter-tie capacity to neighbouring jurisdictions by 2,000 MW by May 1, 2005. On May 1, 2005, approvals for some projects were in place but there was limited progress on adding capacity. There are projects now underway or pending completion in Michigan and Québec. See "Description of the Business – Our Transmission Business – Projects Relating to Interconnection Capacity." The OEB has been kept informed of our progress and we have updated the OEB since May 1, 2005 to enable their assessment of our efforts.

- ***Information Disclosure*** – We are required to maintain records, provide the OEB with information it may require from time to time and inform the OEB of any material change in circumstances no more than 20 days after the date of occurrence.

- ***Restrictions on Provision of Information*** – We are restricted in our use and disclosure of information pertaining to consumers, retailers, wholesalers and generators. We must obtain consent for disclosure of such information, except in certain specified situations and inform such parties of the conditions under which their information may be disclosed without their consent.

Distribution Licences

The terms and conditions of our three distribution licences are similar to the terms and conditions of our transmission licence described above. In addition, these licences:

- ***Separation of Business Activity*** – require the distribution business to keep its financial records separate from those of the transmission business;

- ***Distribution Rates*** – create an obligation to charge rates in accordance with an order of the OEB and in accordance with the methods or techniques set out in the Electricity Distribution Rate Handbook, the Distribution System Code, the Standard Supply Service Code and the Retail Settlement Code;

- ***Code Compliance*** – require compliance with the Retail Settlement Code and the Affiliate Relationships Code for Electricity Distributors and Transmitters;

- ***Commodity Rebates*** – prescribe the manner by which we must pass through any rebates from Ontario Power Generation Inc. to customers; and

- ***Obligation to Connect and Serve*** – impose the obligation on our distribution business to connect a building to our distribution system under prescribed circumstances, and to sell electricity or ensure electricity is supplied to every person connected to our distribution system, in accordance with our distribution rate orders and the Standard Supply Service Code, and to sell electricity to consumers consistent with the terms and conditions of these instruments.

Rate Orders and Related Issues for Hydro One's Businesses

The OEB approves both the revenue requirements of and the rates charged by our regulated businesses. The rates are designed to permit our businesses to recover the allowed costs and to earn a specified annual rate of return on our common equity.

The term "utility rate base" refers to the investment in regulated operations (consisting of gross plant in service, less accumulated depreciation, plus necessary working capital and excluding construction work in process). Utility rate base is used to determine the capital structure for our regulated businesses, enabling a determination of approved financing charges and return on common equity for them. In 1999, the OEB approved a capital structure for our regulated businesses of 60% debt with a weighted average cost of approximately 7.7%, 4% preferred equity with a 5.5% dividend rate and 36% common equity.

See "General Development of the Business" for a review of the considerable changes made to the regulation of utility charges since Open Access.

Transmission

Current Rate Orders and Review of the Existing Transmission Rate Structure

For 2000, the rate order issued by the OEB for our transmission business (effective on April 1, 1999) approved an annual revenue requirement of $1.2 billion. In determining the revenue requirements, the OEB approved a utility rate base of $5.7 billion, a level of net costs and expenses of $549 million, and a level of payments in lieu of corporate income tax of $139 million for 2000.

On January 15, 2001, the OEB issued another rate order which included approved transmission rates that would have only applied to our transmission customers. Subsequently, it decided to establish a process involving all electricity transmitters within Ontario to develop uniform transmission rates that would apply to all transmission customers. On April 30, 2002, the OEB approved transmission rates that apply uniformly to the hourly peak demand at any transmission delivery point in Ontario. Our approved revenue requirement and load forecast remain unchanged as a result of the adoption of uniform rates. In addition, the OEB's adoption of the uniform transmission rate reduces the financial incentive for customers to seek an alternative transmission provider. The IESO collects transmission revenues for our company and remits these to us on a monthly basis.

On October 26, 2005, the OEB initiated a proceeding to review our transmission rates and to approve revenue requirements for 2006, 2007, and 2008. Revised transmission rates are expected to be implemented in 2007. In the first phase of this proceeding, the OEB considered options to track net income excesses or deficiencies from OEB-approved returns for the period from January 1, 2006 until the revised transmission rates are implemented.

On November 23, 2005, we proposed to the OEB an earnings-sharing mechanism that would result in excess or deficient earnings being tracked. Excess earnings would be returned to customers in the form of transmission system expansion projects that are critical to the economic health of Ontario and secure operation of the system. On February 21, 2006, the OEB announced a decision to adopt an earnings sharing mechanism to equally share, between our shareholder and customers, any transmission earnings in excess of the approved rate of return of 9.88% for the period January 1, 2006 until new rates are set. Consequently, 50% of our excess earnings recovered from customers are deferred as a regulatory liability. This decision had the effect of reducing our transmission revenues by $33 million in 2006.

The second phase of the proceeding is currently underway. Hydro One Networks' 2007 and 2008 Transmission Revenue Requirement and Rate Application was filed with the OEB on September 12, 2006. The key approvals requested include:

- Transmission revenue requirements of $1,263 million for 2007 and $1,298 million for 2008, representing less than a 0.5% year over year increase on an average total customer's bill;
- Capital structure of 56% debt / 4% preferred equity and 40% common equity and a return on equity of 10.5%; and

- A formulaic approach for adjusting our revenue requirements for 2009 and 2010 to improve regulatory efficiency going forward and enable us to focus on our large work plan.

The hearing for the second phase of the 2007 and 2008 Transmission Revenue Requirement and Rate Application is expected to take place in mid-April 2007.

On December 8, 2005, the OEB adjusted the revenue allocation factors for the Province's electricity transmitters such that the share of revenue allocated to Great Lakes Power Ltd. increased to reflect its approved revenue requirement. As a result, our share of overall provincial transmission revenue decreased by approximately $13 million per year beginning in 2006. This will continue until the OEB makes a rate change as a result of our transmission application.

Current transmission rates are based on the fully allocated cost associated with providing each of the following three transmission service elements:

- ***Network services*** — the transmission network is the integrated part of our high voltage transmission system that is shared by all users and includes all 500 kV facilities, the 230 kV and the 115 kV facilities that can be classified as commonly used;
- ***Line connection services*** — connection facilities are the radial parts of our high voltage transmission system, which are dedicated to serving a single customer or generator or a group of customers or generators. Transmission line connection facilities are the radial high voltage transmission lines connecting the transformer to the network; and
- ***Transformation connection services*** — the transformation connection assets consist of the high voltage transformation facilities that step down voltages from transmission levels to distribution levels to supply customers.

In addition, electricity exports from Ontario are levied an export charge for transmission of one dollar per MWh.

Competition

Under the *Ontario Energy Board Act, 1998*, any licensed competitor can apply to the OEB for approval to build transmission network facilities in Ontario. The OEB's adoption of the uniform transmission rate reduces the financial incentive for customers to seek alternative transmission.

Customers historically had the option to build and own their own transmission connection facilities and thereby avoid paying our connection charge. Only a few large industrial customers and local distribution companies chose to do so, likely because of the significant costs of construction. Under the new regulatory framework, in addition to avoiding our connection charge, local distribution companies that own their transmission connection facilities can include these assets in their rate base and earn a regulated return. Customers will generally, however, continue to have the option to have their new connection facilities incorporated within our existing transmission transformation and line pools or to build and own their new connection facility. We expect to continue to maintain and restore our existing connection assets, as well as bid on the construction and ownership of new facilities.

By-pass

By-pass occurs when we have invested in the provision of transmission facilities to a customer which then obtains all or part of its transmission services in another manner or takes action to avoid its use of transmission services before the rates collected have paid for the investment. Recovery of the remaining costs for the stranded facilities then necessitates higher transmission rates from the remaining customers.

In its January 2001 decision respecting transmission rate design and cost allocation, the OEB addressed the issue of by-pass where a load customer installs a generator to serve all or part of its load. The OEB decided that customers would be assessed line and transformation connection charges based on their total demand for electricity, or gross load. However, given the desire to encourage new generation and the growth anticipated in the usage of the network (which would hold us harmless from the effects of stranding), customers would be assessed network charges based on their net load. In effect, customers who generate electricity on-site can save the network charges otherwise applicable to their purchase of electricity generated by third parties. The decision to assess line and transformation connection charges based on gross loads means that on-site generators bear a portion of the costs associated with Ontario's transmission infrastructure, thereby mitigating the potentially negative effect of on-site generation on our transmission business.

Although the January 2001 decision clarified the by-pass situation and the charges to be applied to load customers which install generation, two companies, Abitibi-Consolidated Company of Canada Limited and CASCO Inc., requested relief from the obligation to pay transmission charges. Despite our opposition, on September 4, 2003, the OEB awarded both companies net load billing on their line connection and network transmission rates with retroactive application to May 1, 2002. Despite having Hydro One refund $2.8 million in total to the two companies, the OEB disallowed a deferral account to record this amount for future recovery.

In August, 2005, following an extensive consultation process, the OEB issued a revised Transmission System Code, which implements its June 2004 decision on principles relating to transmission by-pass, among other things. See "Regulation – Contractual Arrangements, Codes and Licences – Electricity Industry Codes."

Facilities Applications

With the creation of the OPA, the process for seeking approval of future large transmission projects has changed. Such projects will have to be factored into the IPSP, which the OPA must submit to the OEB for approval. Once approved, transmitters are required to conduct an environmental assessment, as well as apply to the OEB for leave to construct. Cost recovery of the facility then needs a final approval from the OEB as part of a transmission rate application.

On November 14, 2006, the OEB issued filing requirements for transmission applications which include filing requirements for leave to construct electricity transmission projects under section 92 of the *Ontario Energy Board Act, 1998*. Until there is an OEB approved IPSP, these requirements will be used to ensure a complete review of proposed transmission projects.

Transmission Corridors

On June 27, 2002, the Province passed the *Reliable Energy and Consumer Protection Act, 2002* that provided for, among other things, ownership of all transmission corridor and abutting lands to be transferred from us to the Province in exchange for a statutory right to use the lands for transmission and distribution purposes effective December 31, 2002. Certain of these lands have been subsequently transferred back to Hydro One. See "Interests of Management and Others in Material Transactions – Relationship with Province and Other Parties – Transmission Corridors."

Distribution

Current Rate Orders and Distribution Rate Structure

With the introduction of the *Ontario Energy Board Amendment Act (Electricity Pricing), 2003*, distributors were able to start recovering certain distribution regulatory assets in their rates on an interim basis, beginning March 1, 2004. On January 28, 2004, we filed an application with the OEB, to adjust our distribution rates for interim recovery of the regulatory assets identified in the *Electricity Pricing, Conservation and Supply Act, 2002* for the first year of the four year recovery period commencing April 1, 2004. On December 9, 2004, the OEB issued its final decision which approved a total of $144 million for recovery, comprising account balances in Hydro One's retail settlement variance accounts, market ready costs, secondary environmental deferral accounts, deferred low voltage costs and other regulatory assets.

On August 17, 2005, Hydro One filed a Distribution Rate Application seeking approval for a $160 million increase in the 2006 revenue requirement for our distribution business to a total of $965 million. This revenue requirement was based on achieving a 9.0% return on equity, consistent with the OEB's guidance for setting 2006 rates. Hydro One requested the full revenue requirement to recover all costs as well as recovery of regulatory assets incurred from January 1, 2004 to April 30, 2006. An oral hearing commenced in January 2006. On April 12, 2006 the OEB granted full approval of the $965 million revenue requirement. The return on equity was approved at 9.0%. New rates add approximately 4.8% ($6.53 per month) to our typical residential customers' total bill (based upon usage of 1,000 kWh per month). The new rates came into effect on May 1, 2006.

The OEB announced its intention to establish a multi-year distribution rate-setting plan for the years 2007 to 2010. The objectives of the plan are: to provide greater regulatory certainty to distributors during 2007 to 2010; to begin to drive efficiency improvements in the distribution sector; and to lay a foundation for the third generation incentive regulation mechanism. Accordingly the OEB has a number of generic processes currently underway to achieve their objectives. These processes include:

- Cost Allocation: On September 29, 2006, the OEB released a final report on Cost Allocation Review outlining the methodology for distributors to follow in filing with the OEB, for information purposes, a cost allocation study based on the 2006 approved revenue requirement.
- 2nd Generation Incentive Mechanism and Cost of Capital: On December 20, 2006 the OEB issued its final report on the cost of capital and 2nd Generation Incentive Regulation Mechanism including guidelines and filing requirements for the

> preparation of rate applications for 2007 rates. The recommendations include a formulaic approach to establishing 2007 rates with a rate rebasing approach to be staggered across all Ontario distributors between 2008 and 2010. Rebasing of distribution rates is a critical part of the OEB's multi-year electricity distribution rate setting plan. A selection process will be employed to determine which distributors will be rebased in each of three tranche years – 2008, 2009 and 2010. The rate rebasing will be the basis on which the 3rd generation incentive regulation mechanism is applied.

We expect to file our 2007 Distribution Rate Application by the end of February 2007.

In August, 2005, Hydro One filed a distribution rate application seeking approval for a $3 million increase in the 2006 distribution revenue requirement of Hydro One Brampton Networks Inc. to a total of $62.1 million. This rate application follows a separate process with the OEB independent from the Hydro One Networks' distribution application. The OEB rendered its decision on April 12, 2006. The decision approved Hydro One Brampton's distribution revenue requirement of $62.1 million. The overall impact of the decision on a typical residential customer's total bill (based upon usage of 1,000 kWh per month) is expected to be an increase of 1.2% or about $1.30 per month.

Miscellaneous Rate Applications

On November 15, 2005, Hydro One applied to the OEB for approval of rates applicable to distributed electricity generator customers of Hydro One Networks Inc. on an interim basis until we have sufficient information to file for approval of rates based on a cost allocation study. These rates, which comprise the volumetric portion of the charge only, are intended to assist in removing a financial barrier to the implementation of distributed generation in the Province. The OEB issued its decision on April 17, 2006 in which it did not approve the interim rates.

On April 26, 2005, Hydro One received OEB approval for a rate amendment affecting embedded customers connected to the Hydro One Distribution low voltage system that are supplied from multiple delivery points at a single transformation station and who pay retail transmission charges. The amendment allows the aggregation of demand for such customers and is intended to align the basis on which they are charged retail transmission rates to with that employed by the IESO in charging transmission rates to wholesale transmission customers supplied from multiple delivery points at a single transformation station. The reduction in charges to customers will be recovered through the retail settlement variance accounts.

On December 20, 2004, the OEB approved Hydro One's time of use rate pilot program, as an aspect of our CDM program. Customers are eligible for these time of use rates if their electricity consumption in the off-peak period is at least twice that during the on-peak period.

Rate Orders for Remote Communities

Hydro One Remote Communities Inc.'s business is exempt from a number of sections of the *Electricity Act, 1998* which relate to the competitive market. For example, we continue to apply bundled rates to customers in remote communities.

On December 20, 2004, we applied to the OEB for interim approval of our CDM plan with planned expenditures of $300,000 for a one-year program. This application was not intended to change the current rates for our remote customers in 2005, but instead, to implement a deferral account, with disposition of this account to be addressed in the next rate application. The plan was approved on an interim basis, as filed, on February 2, 2005.

On October 26, 2005, we applied to the OEB for approval of our revenue requirement and new electricity rates for our remote customers for implementation on May 1, 2006. This application requested approval of a revenue requirement of $35.5 million, the establishment of Rural and Remote Rate Protection ("RRRP") at its current level, adjustments to reflect anticipated fuel cost increases in 2006 and the cost of an on-going CDM program, inclining block conservation rates for our Non-Standard A Residential and General Service customers, as well as exemptions from certain sections of the Distribution System Code. On April 26, 2006, the OEB rendered a decision on the main components of the application, approving the revenue requirement, CDM program and customer rates. An amended decision, clarifying the April 26, 2006 decision with respect to RRRP was issued on May 10, 2006. The new rates were implemented on May 1, 2006.

Rural and Remote Rate Protection

In approving electricity rates for a distributor which delivers electricity to rural or remote consumers, the OEB is required to provide rate protection for prescribed classes of consumers, including those who received rural rate assistance prior to April 1, 1999, by reducing the rates that would otherwise apply.

From April 1, 1999 until the present, the amount of rate reduction for rural consumers who occupy rural residential premises is $127 million per year less the specific amounts established for certain specified municipalities and distributors in three former remote communities.

Our remote customers received a rate reduction in the amount of $21 million for 2002, 2003, 2004 and 2005 based on the amount that they received in 2001. In 2006, our remote customers received a rate reduction in the amount of $21 million. This amount was set by the OEB according to the rules set out in the regulations under the *Ontario Energy Board Act, 1998*.

Under the *Ontario Energy Board Act, 1998*, a distributor is entitled to be compensated for lost revenue resulting from the rate protection regime, and all consumers are required to contribute towards the amount of any compensation to the distributors, such as our company, for rate protection. As of May 1, 2002, the amounts required to compensate the distributors were collected by the IESO and paid to us for distribution in accordance with the regulation under the *Ontario Energy Board Act, 1998*. The OEB calculates the charge to be collected by the IESO based upon the latter's forecast of the number of kilowatt-hours of electricity that will be withdrawn from the IESO-controlled grid. Hydro One Networks maintains a variance account to track any surplus or deficit in the amount received from the IESO and from the $127 million prescribed amount.

Hydro One Remote Communities Inc.'s business is run on a break even basis. As a result, any net earnings or loss in the year, including rural and remote rate protection amounts, is deferred in a regulatory variance account for inclusion in the calculation of future customer rates.

Competition

Under the *Ontario Energy Board Act, 1998*, there are instances in which it is appropriate for one distributor to transfer its customers to another distributor. The acquiring distributor is required to obtain amendments to its licence authorizing it to serve in a specific area, but not with exclusive distribution rights to it. The OEB convened a generic hearing in December 2003 to determine the principles which will apply to such licence amendment applications. On February 27, 2004, the OEB issued its decision, with clear principles and filing requirements to be followed for service territory amendment applications. To date, on such applications, Hydro One has co-operated with other distributors on a case-by-case basis to determine the most efficient supplier and has not had to contest any such applications.

In July 2005, as a result of three applications by distributors, another generic proceeding was convened by the OEB to determine issues relevant to inter-utility share acquisitions and amalgamations. In a decision issued on August 31, 2005, the OEB decided that the scope of its review of these applications is appropriately dictated by Section 86 of the *Ontario Energy Board Act, 1998* and its objectives as stated. It also decided that reviews of the related transaction processes themselves are beyond its purview.

RISK FACTORS

Ownership by the Province

The Province owns all of our outstanding shares. Accordingly, the Province has the power to determine the composition of our Board of Directors and appoint the Chair, and thus influence our major business and corporate decisions. We and the Province have entered into a shareholder's agreement relating to certain aspects of the governance of our company. This agreement requires us to consult with the Province in connection with our business plans and dividend policy and obtain approval from the Province in advance of: (i) any proposal to issue or transfer shares in our company or our subsidiaries; (ii) any major transaction which could potentially have a material effect on the financial interest of the Province; or (iii) our ability to make proxy tax payments to OEFC.

Conflicts of interest may arise between us and the Province as a result of the obligation of the Province to act in the best interests of the residents of Ontario in a broad range of matters, including the regulation of Ontario's electricity industry and environmental matters, any future sale or other transaction by the Province with respect to its ownership interest in our company, the Province's ownership of Ontario Power Generation Inc., and the determination of the amount of dividend or proxy tax payments. We may not be able to resolve any potential conflict with the Province on terms satisfactory to us which would have an adverse impact on our business.

Regulatory Risk

We are subject to regulatory risks including the risk that rates for our transmission and distribution businesses that permit us to recover on a timely basis the estimated costs of providing service and earn approved rates of return are subject to the approval of the OEB. Our ability to earn the approved rates of return depends on achieving the forecasts established in the rate-setting process.

On September 12, 2006, our subsidiary Hydro One Networks ~~filed,~~ with the OEB, its application and evidence in support of its 2007 and 2008 transmission revenue requirements. Operations, maintenance and administration expense levels have increased over time and, our transmission business rate base has increased, reflecting prudent expenditures, since transmission rates were initially established. However, there is the risk that these increases may be disallowed by the OEB. Any disallowed expenditures relating to past capital projects would be charged to the results of operations in the period that the OEB renders its decision. We are also seeking to change our current capital structure to a higher equity component. The increased ratio of common equity as well as an increased return on equity are expected to be challenged by the OEB and intervenor groups. Insufficient funding for our transmission business could adversely impact our financial results and the operating performance of the transmission system.

The OEB approves our transmission and distribution rates based on projected electricity load and consumption levels. If actual load or consumption falls below projected levels, our rate of return for either, or both, of these businesses could be adversely affected. Also, our current revenue requirements for these businesses are based on cost assumptions that may not materialize. There is no assurance that the OEB would allow rate increases sufficient to offset unfavourable financial impacts from unanticipated changes in electricity demand or in our costs.

The load we deliver, in particular transmission, could be reduced by successful CDM programs. Current requirements for CDM call for a 5% reduction in Ontario's projected peak electricity demand by 2007, which could significantly reduce our revenues. The OEB has recognized the need to compensate utilities for any resulting lost revenue, but the approach, level and timing of any such compensation mechanism is yet to be determined. We are also subject to risk of revenue loss from other factors. For example recent revisions to the OEB's Transmission System Code have resulted in customers gaining the right to bypass some of our transformation facilities by constructing their own assets (under certain conditions) and compensating us by paying the net book value of bypassed assets as well as costs of removal and environmental remediation. This code revision could result in significant future revenue loss to our transmission business. The Transmission System Code enables us to challenge investments by utility customers that may strand our assets.

There is also a risk we could be required to invest in large-scale transmission infrastructure projects or incur unexpected capital expenditures to maintain or improve our assets and to connect new third-party generation assets. The Province has passed regulations authorizing us to procure smart meters. Currently we are authorized to only recover 30 cents per residential customer per month of the associated costs in rates subject to final approval from the OEB. Total project costs are anticipated to be significant. While we expect all of these expenditures to be fully recoverable, any future regulatory decision to disallow or limit the recovery of such costs would lead to potential impairment and charges to operations which may have an adverse effect on our business.

Asset Condition

Hydro One continually maintains its assets to provide reliable service and to accommodate customer needs. However our installed asset base is aging and therefore requires increased maintenance, major refurbishment or replacement to maintain their performance. While we plan (subject to OEB approval) to increase capital and maintenance expenditures with respect to existing assets for the next several years to maintain their performance or replace them as they reach the end of their life, execution of these plans is dependent on external factors. For example, opportunities to remove equipment from service to accommodate construction and maintenance are becoming increasingly limited due to growing loads. If we are unable to carry out these plans, in a timely and optimal manner, the reliability of the provincial grid, our ability to deliver sufficient electricity and/or customer supply security will be compromised and the costs of operating and maintaining these assets will increase. This could have an adverse impact on our company.

Risk Associated with Transmission Projects

The amount of power which may flow through transmission networks is constrained due to the physical characteristics of transmission lines and operating standards established by North American standards authorities (i.e., NERC and NPCC).

Within Ontario, new and expected generation expansions and load growth have increased such that parts of Hydro One's transmission and distribution systems are operating at or near capacity. These constraints or bottlenecks limit the ability of Hydro One's networks to reliably transmit power from new and existing generation sources (including, expanded interconnections with neighbouring utilities) to load centres or meet customers increasing loads. As a result, investments are needed to increase transmission capacity and enable the reliable delivery of power from existing and future generation sources to Ontario consumers.

These investments are, in most cases, subject to receipt of OEB approvals which can include expropriation, environmental approval(s) and consultation with First Nations (which may include accommodation) where traditional lands or lands subject to land claims are involved. These approvals may not be obtained in a timely fashion or at all. The ability to make such investments may also be impacted by public opposition to the proposed site of transmission investments.

If we are unable to make necessary investments to increase transmission capacity due to the inability to obtain approvals in a timely fashion (or at all) or due to public opposition, this could have a material adverse effect on our transmission reliability, our ability to deliver sufficient electricity, and our company.

Work Force Demographic Risk

Approximately 25% of our employees will be eligible for retirement by 2008. In some parts of the organization, the risk is much higher. Accordingly, our success will be tied to our ability to attract and retain sufficient qualified staff to replace those retiring. This will be challenging as we expect the skilled labour market for our industry to be highly competitive in the future. In addition, many of our employees possess experience and skills that will also be highly sought after by other organizations both inside and outside the electricity sector. We have already lost a considerable number of management staff, both those in executive positions and those who are logical successors for executive positions, to opportunities in other electricity sector positions across Canada (and, in particular, in Ontario) as well as senior positions outside of the sector. Moreover, we must also continue to advance our training and apprenticeship programs and succession plans to ensure that our future operational staffing needs will be met. If we are unable to attract and retain qualified personnel, it could have a material adverse effect on our company.

Labour Relations Risk

The substantial majority of our employees are represented by either the PWU or the Society. Over the past several years, significant effort has been expended to increase our flexibility to conduct operations in a more cost efficient manner. Although we believe that we have achieved improved flexibility in our collective agreements, including a reduction in pension benefits similar to a previous reduction affecting management staff, we may not be able to achieve further improvement. Existing collective agreements with the PWU and the Society will expire on March 31, 2008. We face financial risks related to our ability to negotiate collective agreements consistent with our rate orders. In addition, in the event of a labour dispute, we could face some degree of operational risk related to continued compliance with our licence requirements of providing service to customers.

Environmental Risk

We are subject to extensive Canadian federal, provincial and municipal environmental regulation. Failure to comply could subject us to fines and other penalties. In addition, the presence or release of hazardous or other substances could lead to claims by third parties and/or governmental orders requiring us to take specific actions such as investigating, controlling and remediating the effects of these substances. We are currently undertaking a voluntary land assessment and remediation program covering most of our stations and service centres. It involves the systematic identification of any contamination at or from these facilities, and, where necessary, the development of remediation plans for our company and adjacent private properties. Any contamination on our properties could limit our ability to sell these assets in the future.

There is also risk associated with obtaining governmental approvals, permits, or renewals of existing approvals and permits related to constructing or operating facilities. This may require environmental assessment or result in the imposition of conditions, or both, which could mean delays and cost increases.

Future changes in environmental regulations may result in material changes to our estimates of future expenditures to complete this work. On November 4, 2006, Environment Canada published new draft regulations, governing the management of polychlorinated biphenyls (PCBs). It is expected that these draft regulations will be finalized later in 2007. We have estimated the non-capital expenditures for complying with these draft regulations to be between $250 million and $375 million which are in excess of amounts we have already recorded as environmental liabilities on our balance sheet. If required, most of these additional expenditures would be incurred in the 2013 to 2025 period. No obligation has been recorded in the financial statements for these increased expenditures due to continued uncertainty regarding the timing and content of the final regulations. In any case, actual future environmental expenditures may vary materially from the estimates used in the calculation of the environmental liabilities on our balance sheet. We do not have insurance coverage for these environmental expenditures.

Scientists and public health experts have been studying the possibility that exposure to electric and magnetic fields emanating from power lines and other electric sources may cause health problems. If it were to be concluded that electric and magnetic fields present a health risk, we could face litigation, be required to take costly mitigation measures such as relocating some of our facilities or experience difficulties in locating and building new facilities.

Risk of Natural and Other Unexpected Occurrences

Our facilities are exposed to the effects of severe weather conditions, natural disasters and, potentially, catastrophic events, such as a major accident or incident at a facility of a third party (such as a generating plant) to which our transmission or distribution assets are connected. Although constructed, operated and maintained to industry standards, our facilities may not withstand occurrences of this type in all circumstances. We do not have insurance for damage to our transmission and distribution wires, poles and towers located outside our transmission and distribution stations resulting from these events. Losses from lost revenues and repair costs could be substantial, especially for many of our facilities that are located in remote areas. We could also be subject to claims for damages caused by our failure to transmit or distribute electricity. Our risk is partly mitigated because our transmission system is designed and operated to withstand the loss of any major element and possess inherent redundancy (e.g. several interconnections with utilities in other provinces and the United States) that provides alternate means to deliver large amounts of power. In the event of a large uninsured loss we would apply to the OEB for recovery of such loss, however, there can be no assurance that the OEB would approve any such applications, in whole or in part, which could have a material adverse effect on our net income.

Risk Associated with Arranging Debt Financing

We expect to borrow to repay our existing indebtedness and fund capital expenditures. We have substantial amounts of existing debt which mature between 2007 and 2010, including $395 million maturing in 2007 and $500 million maturing in 2008. We also plan to incur total capital expenditures of approximately $1.25 billion in 2007, $1.35 billion in 2008, and $1.5 billion in 2009. Cash generated from operations, after the payment of expected dividends, will not be sufficient to fund the repayment of our existing indebtedness and capital expenditures. Our ability to arrange sufficient and cost effective debt financing could be adversely affected by numerous factors, including the regulatory environment in Ontario, our results of operations and financial position, market conditions, the ratings assigned to our debt securities by credit rating agencies and general economic conditions. Any failure or inability on our part to borrow substantial amounts of debt on satisfactory terms could impair our ability to repay maturing debt, fund capital expenditures and meet other obligations and requirements and, as a result, could have a material adverse effect on our company.

Pension Plan Risk

We have a defined benefit registered pension plan for the majority of our employees. Contributions to the pension plan are established by actuarial valuations which are filed with the Financial Services Commission of Ontario on a tri-annual basis. The most recently filed valuation was prepared as at December 31, 2003 pursuant to which we commenced making contributions effective January 1, 2004 of approximately $80 million per year. The next valuation is required to be prepared as at December 31, 2006 and must be filed on or before September 30, 2007. The required level of contributions effective January 1, 2007 will depend on future investment returns, changes in benefits or actuarial assumptions. Based on current factors, we estimate annual pension contributions for 2007 and beyond to be up to $100 million per year. A determination by the OEB that some of our pension expenditures are not recoverable from customers would have a negative impact on our company.

Risk from Transfer of Assets Located on Indian Lands

The transfer orders by which we acquired certain of Ontario Hydro's businesses as of April 1, 1999 did not transfer title to some assets located on lands held for bands or bodies of Indians under the *Indian Act* (Canada). See "Interest of Management and Others in Material Transactions – Relationships with the Province and Other Parties – Transfer Orders." Currently, OEFC holds these assets. Under the terms of the transfer orders, we are required to manage these assets until we have obtained all consents necessary to complete the transfer of title of these assets to us. We cannot predict the aggregate amount that we may have to pay, either on an annual or one-time basis, to obtain the required consents. However, we anticipate having to pay more than the approximately $850,000 per year that we currently are paying to these Indian bands and bodies. If we cannot obtain consents from the Indian bands and bodies, OEFC will continue to hold these assets for an indefinite period of time. If we cannot reach a satisfactory settlement, we may have to relocate these assets from the Indian lands to other locations at a cost that could be substantial or, in a limited number of cases, to abandon a line and replace it with diesel generation facilities. The costs relating to these assets could have a material adverse effect on our net income if we are not able to recover them in future rate orders.

Risk from Provincial Ownership of Transmission Corridors

Pursuant to the *Reliable Energy and Consumer Protection Act, 2002*, the Province acquired ownership of our transmission corridor lands underlying our transmission system. Although we have the statutory right to use the transmission corridors, we may be limited in our ability to expand our systems. Also, other uses of the transmission corridors by third parties in conjunction with the operation of our systems may increase safety or environmental risks.

Risk Associated with Information Technology Infrastructure

Our ability to operate effectively in the Ontario electricity market is in part dependent upon us developing, maintaining and managing a complex information technology systems infrastructure. Computer systems are employed to operate our transmission and distribution facilities, financial and billing systems and to capture data and to produce timely and accurate information used in our business. Failures of these systems could have a material adverse effect on our business, operating results, financial condition or prospects.

Risk Associated with Outsourcing Arrangement

Consistent with our strategy of reducing operating costs, we entered into an outsourcing services agreement in 2002 with Inergi LP, an affiliate of CapGemini Canada Inc. See "Description of the Business – Outsourcing Arrangement with Inergi LP." If the agreement with Inergi LP is terminated for any reason, we could be required to incur significant expenses to re-establish all or some of the functions involved, which could have a material adverse effect on our net income.

Market and Credit Risk

Market risk refers primarily to the risk of loss that results from changes in commodity prices, foreign exchange rates and interest rates. We do not have commodity risk and our foreign exchange risk is currently insignificant, although we could in future decide to issue foreign currency denominated debt. We are exposed to fluctuations in interest rates as our maturing long-term debt is refinanced. We periodically utilize interest rate swap agreements to mitigate elements of interest rate risk. We estimate that a one percent change in interest rates on the refinancing of long-term debt maturing in 2007 and 2008 would have an impact on net income of approximately $2 million and $4 million respectively.

Financial assets create a risk that a counter-party will fail to discharge an obligation, causing a financial loss. Derivative financial instruments result in exposure to credit risk, since there is a risk of counter-party default. We monitor and minimize credit risk through various techniques, including dealing with highly-rated counter-parties, limiting total exposure levels with individual counter-parties, and by entering into master agreements which enable net settlement. We do not trade in any energy derivatives. We currently have one interest rate swap contract outstanding with a notional principal amount of $40 million. The fair value of the swap contract is not significant.

Currently, there are no significant concentrations of credit risk with respect to any class of financial assets. We are required to procure electricity on behalf of competitive retailers and embedded local distribution companies for resale to their customers. The resulting concentrations of credit risk are mitigated through the use of various security arrangements, including letters of credit, which are incorporated into our service agreements with these retailers in accordance with the OEB's Retail Settlements Code.

DIVIDENDS

Dividends on our common shares and Series A preferred shares are declared at the discretion of our Board of Directors, and are recommended by our management based on our results of operations, financial condition, cash requirements and other relevant factors, such as industry practice and shareholder expectations.

Our company's policy is to declare and pay cash dividends on our common shares on the basis of a calculation involving our regulated net income net of preferred dividends and non-regulated net income. Any factor that adversely affects our company's net income would likely be reflected in our dividend payments.

We declared and paid to the Province annual dividends on our outstanding 100,000 common shares totalling $332 million in 2006 as compared with $273 million in 2005 and $247 million in 2004. We declared and paid to the Province a total annual cumulative dividend on our outstanding 12,920,000 series A preferred shares of approximately $18 million in each of 2006, 2005 and 2004, which was calculated at a rate of $1.375 per annum per share, as stipulated in our company's Articles of Incorporation.

DESCRIPTION OF CAPITAL STRUCTURE

General Description of Capital Structure

The authorized share capital of our company consists of an unlimited number of common shares (the voting shares of our company) and an unlimited number of preferred shares. As at December 31, 2006, 100,000 common shares and 12,920,000 series A preferred shares are issued and outstanding, all of which are owned directly by the Province.

All of our company's voting securities are held by the Province. Accordingly, our company is controlled by the Province.

The common shares are not redeemable or retractable. Holders of our common shares are entitled to one vote per share at meetings of the shareholders of the common shares and to receive dividends if, as, and when declared by the Board of Directors of our company. Holders of common shares are also entitled to participate, pro rata to their holding of common shares, in any distribution of the assets of our company upon its liquidation, dissolution or winding-up. The series A preferred shares, as set forth in our Articles of Incorporation, entitle our company to redeem all or any part of these shares subject to certain terms and conditions as set forth therein. These series A preferred shares are entitled to a dividend at a rate of $1.375 per annum per share.

Our company has not issued any restricted securities.

CREDIT RATINGS

Our company's corporate credit ratings from approved rating organizations are as follows:

Rating Agency	Short-term Debt	Long-term Debt
Standard & Poor's Rating Services ("S&P")	A-1	A
Dominion Bond Rating Service Inc. ("DBRS")	R-1 (middle)	A (high)
Moody's Investors Services Inc. ("Moody's")	Prime-1	Aa3

The following information relating to credit ratings is based on information made available to the public by the rating agencies.

Credit ratings are intended to provide investors with an independent measure of the credit quality of an issue of securities. The rating agencies rate long-term debt instruments by rating categories ranging from a high of "AAA" to a low of "D" ("C" in the case of Moody's). Long-term debt instruments which are rated in the A category by S&P mean the obligor has a strong capacity to meet its financial commitments but are considered somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitments and obligations is still strong. S&P utilizes a plus or a minus modifier to indicate the relative standing within the rating category. Long-term debt instruments which are rated in the A category by DBRS are considered to be of a satisfactory credit quality, with substantial protection of interest and principal. Entities in the "A" category, however, are considered to be more susceptible to adverse economic conditions and have greater cyclical tendencies than higher-rated securities. The "high" modifier indicates relative standing within this rating category by DBRS. Long-term debt instruments which are rated in the Aa category by Moody's are judged to be of high quality and are subject to very low credit risk. Moody's applies numerical modifiers to each generic rating classification from Aa to Caa. The modifier 3 indicates a ranking in the lower end of that generic rating category.

The ratings mentioned above are not a recommendation to purchase, sell or hold our company's debt securities and do not comment as to market price or suitability for a particular investor. There can be no assurance that the ratings will remain in effect for any given period of time or that the ratings will not be revised or withdrawn entirely by any or all of S&P, DBRS and Moody's at any time in the future if in their judgment circumstances so warrant.

MARKET FOR SECURITIES

Our Debentures (7.15%) due 2010, Debentures (7.35%) due 2030, Series 1 Notes (6.40%) due 2011, Series 2 Notes (6.93%) due 2032, Series 3 Notes (5.77%) due 2012, Series 4 Notes (6.35%) due 2034, Series 5 Notes (6.59%) due 2043, Series 6 Notes (4.00%) due 2008, Series 7 Notes (3.950%) due 2009, Series 8 4.100% Extendable Step-up Notes initially due 2007, Series 9 Notes (5.36%) due 2036, Series 10 Notes (4.640%) due 2016 and Series 11 Notes (5.000%) due 2046, together with our OEFC Series 9 Notes (4.45%) due 2007 and our OEFC Series 10 Notes (4.55%) due 2007 are not listed on any exchange or similar market for securities.

Trading Price and Volume

The debt securities issued by our company are not listed on a recognized exchange or quoted on a recognized quotation and trade reporting system.

Prior Sales

Our company issued the following tranches of medium term notes in 2006:

Note	Par Value (M) ($)	Sale Price ($)	Gross Proceeds ($)
Series 10 (4.64%) due 2016	300	99.937	$299,811,000
Series 9 (5.36%) due 2036	250	99.228	$248,070,000
Series 10 (4.64%) due 2016	150	99.201	$148,801,500
Series 11 (5.00%) due 2046	75	99.828	$74,871,000

DIRECTORS AND OFFICERS

Directors

The following table sets forth the name, municipality of residence and principal occupation of each of our directors, as of December 31, 2006.

Name and Municipality of Residence	**Principal Occupation**
Rita Burak (2) Toronto, Ontario Canada (Director since June 11, 2002 and Chair since May 30, 2003)	Chair of the Board of Directors of Hydro One Inc.
Sami Bébawi (4)(5) Outremont, Québec Canada (Director since October 8, 2004)	Executive Vice-President, Member, Office of the President SNC-Lavalin Group Inc. President, Socodec Inc.
Murray J. Elston (1)(3)(4) Manotick, Ontario Canada (Director since June 11, 2002)	President and C.E.O., Canadian Nuclear Association
Don MacKinnon (4)(5) Chatsworth, Ontario Canada (Director since June 11, 2002)	President, Power Workers' Union
Eileen A. Mercier (1)(2)(6) Toronto, Ontario Canada (Director since August 15, 2002)	Corporate Director
Walter Murray (1)(3)(6) Bracebridge, Ontario Canada (Director since November 10, 2005)	Corporate Director
Kathleen O'Neill (1)(2)(3) (6)(7) Toronto, Ontario Canada (Director since July 27, 2005 but resigned effective January 24, 2007)	Corporate Director

Name and Municipality of Residence	**Principal Occupation**
Douglas E. Speers (1)(5)(6) Coldwater, Ontario Canada (Director since November 10, 2005)	Chairman and Director, Emco Corporation
Kenneth D. Taylor (4)(5) NewYork, NewYork USA (Director since June 11, 2002)	Chair, Taylor and Ryan Inc.
Blake Wallace (2)(3)(4) Toronto, Ontario Canada (Director since November 22, 2002)	Vice President and Director, Murray & Company

(1) Member of the Audit and Finance Committee

(2) Member of the Corporate Governance Committee

(3) Member of the Human Resources and Public Policy Committee

(4) Member of the Regulatory and Environment Committee

(5) Member of the Health and Safety Committee

(6) Member of the Information Technology Committee

(7) Ms. O'Neill resigned from our Board of Directors effective January 24, 2007. Until her resignation, Ms. O'Neill was the Chair of the Corporate Governance Committee and a member of the Audit and Finance Committee, the Human Resources and Public Policy Committee and the Information Technology Committee.

Rita Burak was appointed Chair of Hydro One Inc. on May 30, 2003. She served as the Vice Chair of our Board of Directors from August 22, 2002 to May 30, 2003. She is also a Director of The Equitable Life Insurance Company of Canada and the President of a consulting partnership, The Network Executive Team, Management Consultants, Inc. and has held such posts since 2003 and 2001, respectively. Ms. Burak is the Vice Chair of the University of Guelph and a member of the University Health Network Board of Trustees and the TELUS Ontario Advisory Committee and Chair of the Toronto Community Board. From 1995 to 2000, she served as Secretary of the Cabinet in Ontario and is a Member of the Order of Ontario. Ms. Burak has been a Director of our company since June 11, 2002.

Sami Bébawi is the president of his own construction project management company, Geracon Inc. From 1999 until December 31, 2006 he was an Executive Vice President of SNC-Lavalin

Group Inc. and member of the Office of the President and President of the heavy construction company Socodec Inc. Mr. Bébawi also had the corporate responsibility in project management policy. He is an engineering graduate with a Masters Degree and has several years of experience in designing and building thermal, hydro and nuclear power plants. Mr. Bébawi is a Member of the Ordre des ingénieurs du Québec and is a conjunct professor at Concordia University, Montreal. Mr. Bébawi has been a Director of our company since October 8, 2004.

Murray J. Elston was appointed President and CEO of the Canadian Nuclear Association ("CNA"), effective January 5, 2004. The CNA is a non-profit organization that represents the nuclear industry in Canada and promotes the development and growth of nuclear technologies for peaceful purposes. He previously served as President of Canada's Research-Based Pharmaceutical Companies, a national association representing over 60 research-based pharmaceutical companies, to which he was appointed in November 1998. From 1981 to 1994, he served as a Liberal MPP in the Ontario Legislature, where he held the positions of Minister of Health, Chairman of Management Board, Minister of Financial Institutions and Chairman of the Public Accounts Committee. Mr. Elston is past Chair of the University of Ottawa Institute of Mental Health and Research and the Chair of the Walkerton Clean Water Centre. He is also a member of the Board of the Canadian Nurses Foundation. Mr. Elston has been a Director of our company since June 11, 2002.

Don MacKinnon has been President of the Power Workers' Union, an electricity industry workers union, since May 2000 and a lineman by trade since 1971. He was Vice-President of the Union for 11 years prior to being elected President. In 2000, Mr. MacKinnon was appointed by the Minister of Energy, Science and Technology to the Electricity Transition Committee. He was a member of the Board of Directors of the Electrical and Utilities Safety Association and the Retail Management Board of Ontario Hydro. In 2003, Mr. MacKinnon was appointed by the Minister of Energy to the government's Electricity Conservation and Supply Task Force. In 2005, Mr. MacKinnon became a member of the Canadian Nuclear Association's Board of Directors. Mr. MacKinnon has been a Director of our company since June 11, 2002.

Eileen A. Mercier formed her own management consulting firm, Finvoy Management Inc., specializing in financial strategy, restructuring and corporate governance issues, in 1995. Prior to that time, she was Senior Vice-President and Chief Financial Officer of Abitibi-Price Inc. As an active member of the Board of Directors of several business and not for profit institutions, Mrs. Mercier's affiliations include: CGI Group Ltd., Teekay Shipping Corporation, ING Bank of Canada, ING Canada Inc., Shermag Inc., The University Health Network and York University. In January 2007, Mrs. Mercier was appointed Chair of the Ontario Teachers' Pension Plan Board. Mrs. Mercier has been a Director of our company since August 15, 2002.

Walter Murray is a former Vice-Chairman and member of the Executive Committee of RBC Capital Markets. Prior to his retirement from the Royal Bank of Canada in April 2005, his 38-year career with the bank included senior responsibility for relationship cover for a portfolio of major Canadian and international accounts, Corporate Banking activities across Canada, and several executive postings, including serving as Regional Executive for RBC's Chicago based, Midwestern USA Corporate Banking operations. Since 2000, Mr. Murray has been a member of Ivernia Inc.'s Board of Directors and Chair of its Audit Committee. Mr. Murray has been a Director of our company since November 10, 2005.

Kathleen O'Neill is a Fellow of the Institute of Chartered Accountants and a member of the Board of Directors of MDS Inc., the TSX Group Inc., and Canadian Tire Bank. Until 2005, Ms. O'Neill was a senior executive with the BMO Financial Group where her most recent position was Executive Vice-President, Personal & Commercial Development, and Head of Small Business Banking, which she held from 2002 - 2004. Prior to joining the BMO Financial Group in 1994, she was a Tax Partner with PricewaterhouseCoopers from 1988 - 1994 where she provided clients with advice on corporate structuring and international tax issues, as well as audit issues. Ms. O'Neill's extensive community experience includes Chair of the St. Joseph's Health Centre's Board of Directors, Toronto (2001 - 2003), as well as Chair of the Centre's Audit & Finance Committee (1996 - 2001), and is currently on several non-profit boards. Ms. O'Neill had been a Director of our company since July 27, 2005, but resigned effective January 24, 2007.

Douglas E. Speers is Chairman and Director of Emco Corporation, a leading Canadian distributor of building materials for the residential, commercial and industrial construction markets. Prior to his appointment as Chairman, Mr. Speers was Emco's President and CEO from 1997 - 2004. Between 1971 and 1988, he held several senior positions with Imperial Oil Ltd. in Canada and Exxon International in New York City. Mr. Speers is a Professional Engineer - Province of Ontario, and is currently the Chair of the Executive Board, Canadian Industry Program for Energy Conservation (a joint industry-Federal Government initiative); Chairman of the Services Board and member of the Advisory Board of the Richard Ivey School of Business. He is a member of the Boards of a number of privately held companies and has been a Director of our company since November 10, 2005.

Kenneth D. Taylor is Chair, Taylor and Ryan Inc., a public affairs consulting company, and is a former Chancellor of Victoria University at the University of Toronto. Mr. Taylor is on the Board of Directors of a number of companies in Canada and the United States. He is the former Canadian Ambassador to Iran and the former Canadian Consul General in New York. Mr. Taylor is the recipient of the United States Congressional Gold Medal and is an Officer of the Order of Canada. Mr. Taylor has been a Director of our company since June 11, 2002.

Blake Wallace, Q.C. is currently Vice President and a Director of Murray & Company, a full-service financial intermediary specializing in commercial, industrial and residential real estate, corporate finance, advisory services (debt and equity), privatizations and public-private partnerships. He has also served as Vice President and General Counsel of Murray & Company since 1972. Mr. Wallace is a former Vice-Chair of TVOntario and has been a Director of our company since November 22, 2002.

Each director is elected annually to serve for one year or until his or her successor is elected or appointed.

Officers

The following table sets forth the name, municipality of residence and position of each of our executive officers as of December 31, 2006. On December 8, 2006, Mr. Tom Parkinson resigned as President and Chief Executive Officer of Hydro One and Ms. Laura Formusa was appointed President and Chief Executive Officer (Acting). Although in December 2006 we announced that a search for a permanent Chief Executive Officer had commenced, a formal search process has not yet begun and is unlikely to begin until after the report of the Agency Review Panel. See

"Statement of Executive Compensation" for information concerning payments to Mr. Parkinson upon his resignation.

Name and Municipality of Residence	**Position With Our Company**
Laura Formusa Toronto, Ontario Canada	President and Chief Executive Officer (Acting)
Beth Summers Oakville, Ontario Canada	Chief Financial Officer
Myles D'Arcey Ancaster, Ontario Canada	Senior Vice President, Customer Operations
Tom Goldie Mississauga, Ontario Canada	Senior Vice President, Corporate Services
Nairn McQueen Dundas, Ontario Canada	Vice President, Engineering & Construction Services
Geoff Ogram Toronto, Ontario Canada	Vice President, Asset Management
Wayne Smith Toronto, Ontario Canada	Vice President, Grid Operations

Laura Formusa was appointed as President and Chief Executive Officer (Acting) on December 8, 2006 after serving as the General Counsel and Secretary of Hydro One Inc. since January 2, 2003. She joined Ontario Hydro in 1980 and has held the positions of Assistant General Counsel and General Counsel and Secretary of Hydro One Networks Inc.

Beth Summers was appointed as Chief Financial Officer on May 7, 2004 after serving as Corporate Controller of Hydro One Networks Inc. Prior to joining our company in 2001, Ms. Summers served as Senior Manager, Assurance & Advisory Services with Ernst & Young LLP.

Myles D'Arcey was appointed as Senior Vice President, Customer Operations of Hydro One Networks Inc. on May 1, 2005. Mr. D'Arcey is also President and Chief Executive Officer of Hydro One Remote Communities Inc. He joined Ontario Hydro in 1978 and has held the position of Vice President, Station Services of Hydro One Networks Inc.

Tom Goldie was appointed as Senior Vice-President, Corporate Services of Hydro One Networks Inc. on September 16, 2002. He joined Ontario Hydro in 1977 and has held the position of Vice-President, Human Resources of Hydro One Inc.

Nairn McQueen was appointed as Vice President, Engineering & Construction Services of Hydro One Networks Inc. on August 28, 2002. Prior to joining Hydro One Network Services Inc. in 2000 as Director of Engineering, Mr. McQueen was V.P., Engineering and Project Management Services for Agra Monenco.

Geoff Ogram was appointed Vice President, Asset Management of Hydro One Networks Inc. on January 1, 2005. He joined Ontario Hydro in 1981 and has held the position of Vice President, Strategy & Development of Hydro One Networks Inc.

Wayne Smith was appointed Vice President, Grid Operations of Hydro One Networks Inc. on January 1, 2005. He joined Ontario Hydro in 1980 and has held the position of Director of Investment Planning and Asset Management of Hydro One Networks Inc.

There is no family relationship between any director or officer and any other director or officer.

Indebtedness of Directors and Executive Officers

As of February 1, 2007 and since the beginning of the most recently completed financial year of Hydro One, no director, executive officer, employee, former director, former executive officer or former employee or associate of any director or executive officer of Hydro One or any of its subsidiaries had any outstanding indebtedness to Hydro One or any of its subsidiaries except routine indebtedness or had any indebtedness that was the subject of a guarantee, support agreement, letter of credit or other similar arrangement or understanding provided by Hydro One or any of its subsidiaries other than certain mortgage subsidy payments to Mr. Parkinson, former President and Chief Executive Officer of Hydro One Inc., as described under "Statement of Executive Compensation – Executive Compensation" beginning on p. 66 below.

INTEREST OF MANAGEMENT AND OTHERS IN MATERIAL TRANSACTIONS

Relationships with the Province and Other Parties

Overview

The Province of Ontario owns all of our outstanding shares. As a result, the Province has the power to control all governance decisions affecting us, including the composition of our Board of Directors. Accordingly, the Province exercises control over our policies, the acquisition or disposition of assets, the incurrence of further debt and the payment of dividends to holders of our common and preferred shares.

The OEB is the principal regulator of Ontario's electricity industry. The Province appoints the members of the OEB and fills any vacancies on the OEB. The OEB is obligated to implement approved directives of the Province concerning general policy and objectives to be pursued by the OEB and other directives aimed at addressing existing or potential abuses of market power by industry participants. The IESO directs the operation of our transmission system. The board of directors of the IESO, other than its chief executive officer, is appointed by the Province in accordance with the regulations in effect from time to time under the *Electricity Act, 1998*.

Transfer Orders

The transfer orders pursuant to which we acquired Ontario Hydro's electricity transmission, distribution and energy services businesses as of April 1, 1999 did not transfer any asset, right, liability or obligation where the transfer would constitute a breach of the terms of any such asset, right, liability or obligation or a breach of any law or order. The transfer orders also did not transfer title to some assets located on lands held for bands or bodies of Indians under the *Indian Act* (Canada). The transfer of title to these assets did not occur because authorizations originally granted by the Canadian Minister of Indian and Northern Affairs for the construction and operation of these assets could not be transferred without the consent of such Minister and the relevant Indian bands or bodies or, in several cases because the authorizations had either expired or had never been properly issued. These assets consist primarily of approximately 82 km of transmission lines and distribution lines used to deliver electricity on reserves (of which 14 km of lines are used solely for serving customers off the reserves). OEFC holds these assets.

We are obligated under the transfer orders to manage both the assets held in trust until we have obtained all consents necessary to complete the transfer of title to these assets to us and the assets otherwise retained by OEFC that relate to our businesses. We have entered into an agreement with OEFC under which we are obligated, in managing the assets, to take instructions from OEFC if our actions could have a material adverse effect on it. OEFC has retained the right to take control of and manage the assets, although it must notify and consult with us before doing so and must exercise its powers relating to the assets in a manner that will facilitate the operation of our businesses. The consent of OEFC is also required prior to any disposition of these assets.

The Province also transferred officers, employees, assets, liabilities, rights and obligations of Ontario Hydro in a similar manner to its other successor corporations. These transfer orders include a dispute resolution mechanism to resolve any disagreement among the various transferees with respect to the transfer of specific assets, liabilities, rights or obligations.

The transfer orders do not contain any representations or warranties from the Province or OEFC with respect to the transferred officers, employees, assets, liabilities, rights and obligations. Furthermore, under the *Electricity Act, 1998*, OEFC was released from liability in respect of all assets and liabilities transferred by the transfer orders, except for liability under our indemnity from OEFC as discussed below. By the terms of the transfer orders, each transferee indemnifies OEFC with respect to any assets and liabilities not effectively transferred and is obligated to take all reasonable measures to complete the transfers where the transfers were not effective.

Indemnities

OEFC indemnified us with respect to the failure of the transfer orders to transfer any asset, right or thing or any interest therein related to our business to us and some of our subsidiaries, some adverse claims or interests of third parties or based on title deficiencies arising from the transfer orders, except for some claims and rights of the Crown, and claims related to any equity account previously referred to in the financial statements of Ontario Hydro including amounts relating to any judgment, settlement or payment in connection with litigation initiated by some utilities commissions. The Province has unconditionally and irrevocably guaranteed to us and our subsidiaries the payment of all amounts owing by OEFC under its indemnity.

The indemnity specifically excludes any matter for which we have agreed or are required to indemnify OEFC pursuant to or in connection with any transfer order. It also excludes any claim related to any aboriginal title or rights or the absence of a permit, right-of-way, easement or similar right in respect of lands held for Indian bands under the *Indian Act* (Canada). It also excludes any payment made, or loss, expense or liability incurred by us as a result of the failure of a transfer order to transfer any asset of Ontario Hydro described in the provisions of the transfer order relating to ineffective transfers.

The indemnity does not cover the first $10,000 in value of each claim and only applies to the amount by which the total of all claims exceeds $10 million. We are obliged to pay OEFC a fee for the indemnity of $5 million per year until such time as the parties agree that the indemnity should be terminated. We anticipate that we will require the indemnity until all indemnifiable claims have been identified and finally determined by a non-appealable court order. The indemnity ceases to be available to any of our subsidiary corporations if we cease to control them unless the cessation of ownership results from the sale of the shares of a subsidiary in connection with the enforcement of security on such shares by an arm's-length creditor of Hydro One. The indemnity can be assigned under some conditions with the consent of the Minister of Finance.

The Province has also agreed to indemnify the directors of Hydro One for any liabilities reasonably incurred by them in respect of any civil, criminal or administrative action or proceeding to which they are made a party to the extent that these liabilities result from a claim or determination that their approval of the indemnity by OEFC constituted a breach of their duty to exercise the care, diligence or skill that a reasonably prudent person would exercise in comparable circumstances.

We have indemnified OEFC in respect of the damages, losses, obligations, liabilities, claims, encumbrances, penalties, interest, deficiencies, costs and expenses arising from matters relating to our business and any failure by us to comply with our obligations to OEFC under agreements dated as of April 1, 1999. These obligations include obligations to employ the employees transferred to us under the transfer orders, make and remit employee source deductions, i.e., tax withholding amounts, and employer contributions, manage the real and personal properties which OEFC continues to hold in trust or otherwise and take any necessary action to transfer all of these properties to us, to pay realty taxes and other costs, provide access to books and records and to assume other responsibilities in respect of the assets held by OEFC in trust for us.

Indebtedness

Hydro One incurred debt, on behalf of Hydro One and some of our subsidiaries, in connection with the acquisition of substantially all of the assets, liabilities, rights and obligations of Ontario Hydro's electricity transmission, distribution and energy services businesses. The aggregate principal amount of this debt outstanding as at December 31, 2002 was approximately $2.5 billion and was held by OEFC in the form of notes with varying interest rates and maturity dates from 2002 to 2007. On February 20, 2003, we issued approximately $213,727,000 of additional notes to OEFC pursuant to an agreement between us and OEFC dated February 20, 2003 to evidence payment by us to OEFC of an amount to reduce the rate of interest payable on certain of the then outstanding notes. On March 5, 2003, OEFC sold approximately $2.1 billion of these outstanding notes in a public offering in the Canadian debt capital markets. As a result of this transaction, our company no longer has any indebtedness to OEFC.

Transmission Corridors

On June 27, 2002, the Province passed the *Reliable Energy and Consumer Protection Act, 2002* that provided for, among other things, ownership of all transmission corridor and abutting lands to be transferred from us to the Province in exchange for a statutory right to use the lands for transmission and distribution purposes effective December 31, 2002. Corridor land totalling 49,673 acres with a net book value of approximately $259 million was transferred to the Province. In addition, ownership of land assets with a net value of approximately $7 million, not then in use, was transferred to the Province and applied as a reduction of shareholder's equity. We also retained the obligation to incur certain ongoing expenditures related to our use of this land, including maintenance, property taxes and any future environmental remediation work that may be required by the Province. The OEB is authorized to restrict or discontinue any use of the transmission corridor lands that interferes with the transmission system. The Province later decided to return certain lands to us. During 2003-2005, the Province returned approximately 7,271 acres of lands with a net book value of $38.2 million.

Operational Matters

Hydro One receives its revenues, which are in part collected by the IESO from customers, in accordance with the rules established under the *Electricity Act, 1998* and the *Ontario Energy Board Act, 1998*, as amended from time to time.

Hydro One and the IESO have entered into an operating agreement, which took effect in May 2002, setting out the specific responsibilities of both parties relating to the provision of transmission service. Hydro One also purchases power from the IESO administered spot market (which was administered by Ontario Power Generation Inc. prior to May 2002).

Hydro One has several service agreements with the other successor corporations to Ontario Hydro, primarily Ontario Power Generation Inc. These services include field and engineering, logistics, corporate, telecommunications and information technology services.

Payments in Lieu of Corporate Taxes

We and our subsidiaries are exempt from taxes under the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario) because we are wholly owned by the Province and each of our subsidiaries is, in turn, wholly owned (directly or indirectly) by us. However, pursuant to the *Electricity Act, 1998*, we and each of our subsidiaries are required to pay amounts to OEFC, which are referred to as payments in lieu of corporate taxes or proxy taxes, in respect of each taxation year, generally equal to the amount of tax that we would be liable to pay under the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario) if we were not exempt from taxes thereunder.

Shareholder's Agreement and Dividend Policy

We have entered into a shareholder's agreement with the Province relating to our corporate governance. Under this agreement, we must provide the Province with the financial and non-financial information necessary to allow the Province to periodically inform Ontario's legislature regarding our ongoing performance. This information includes all significant or contentious matters, progress reports concerning compliance with market power mitigation measures, information in respect of all matters requiring shareholder approval and all financial reports. Additionally, the shareholder's agreement requires that we consult with the Province with respect to matters concerning our dividend policy and obtain approval from the Province in advance of any proposal to issue or transfer shares in Hydro One or its subsidiaries, any major transaction, including the sale of assets, which would potentially have a material effect on the financial interest of the Province or our ability to make payments to OEFC or payments in lieu of taxes (proxy taxes) under the *Electricity Act, 1998*.

TRANSFER AGENTS AND REGISTRARS

The trustee and registrar for our company's debt securities is Computershare Investor Services Inc., located in Toronto, Ontario.

The U.S. trustee and registrar for our company's debt securities is Bank of Nova Scotia Trust Company of New York located in New York, New York.

MATERIAL CONTRACTS

Except for the following, since January 1, 2002, our company did not enter into any material contracts, other than contracts in the ordinary course of business:

(a) (i) a third supplemental trust indenture dated as of January 31, 2003 relating to the issuance of Series 4 Notes in the aggregate principal amount of $1,000,000,000, of which $200,000,000 was drawn down on January 31, 2003, $120,000,000 was drawn down on June 25, 2004 and $65,000,000 was drawn down on August 24, 2004, pursuant to the Trust Indenture dated as of June 4, 2001 (the "Trust Indenture");

(ii) a fourth supplemental trust indenture dated as of April 22, 2003 relating to the issuance of Series 5 Notes in the aggregate principal amount of $1,000,000,000, of which $250,000,000 was drawn down on April 22, 2003 and $65,000,000 was drawn down on August 20, 2004, pursuant to the Trust Indenture;

(iii) a fifth supplemental trust indenture dated as of June 23, 2003 relating to the issuance of Series 6 Notes in the aggregate principal amount of $1,000,000,000, of which $500,000,000 was drawn down on June 23, 2003, pursuant to the Trust Indenture;

(iv) a sixth supplemental trust indenture dated as of February 24, 2004 relating to the issuance of Series 7 Notes in the aggregate principal amount of $1,000,000,000, of which $250,000,000 was drawn down on February 24, 2004, pursuant to the Trust Indenture;

(v) a seventh supplemental indenture dated as of November 15, 2004 relating to the issuance of Series 8 Notes in the aggregate principal amount of

$1,000,000,000, of which $40,000,000 was drawn down on November 15, 2004, pursuant to the Trust Indenture;

(vi) an eighth supplemental indenture dated as of May 19, 2005 relating to the issuance of Series 9 Notes in the aggregate principal amount of $1,000,000,000 of which $350,000,000 was drawn down on May 19, 2005, and $250,000,000 was drawn down on April 24, 2006, pursuant to the Trust Indenture;

(vii) a ninth supplemental trust indenture dated as of March 3, 2006 relating to the issuance of Series 10 Notes in the aggregate principal amount of $1,000,000,000 of which $300,000,000 was drawn down on March 3, 2006 and $150,000,000 was drawn down on August 22, 2006, pursuant to the Trust Indenture; and

(viii) a tenth supplemental trust indenture dated as of October 19, 2006 relating to the issuance of Series 11 Notes in the aggregate principal amount of $1,000,000,000 of which $75,000,000 was drawn down on October 19, 2006, pursuant to the Trust Indenture.

Each of these supplemental trust indentures supplement the terms of the Trust Indenture which contains customary covenants and representations by our company for the public issuance of debt securities in the Canadian market.

(b) a Dealer Agreement dated June 24, 2005 between our company and BMO Nesbitt Burns Inc., Casgrain & Company Limited, CIBC World Markets Inc., HSBC Securities (Canada) Inc., Laurentian Bank Securities Inc., National Bank Financial Inc., RBC Dominion Securities Inc., Scotia Capital Inc. and TD Securities Inc. (collectively, the "Dealers") relating to the public offering of unsecured medium term notes of Hydro One in a maximum aggregate principal amount of up to $2,500,000,000. The Dealer Agreement provides for the appointment of the Dealers as non-exclusive agents of Hydro One to solicit, from time to time, offers to purchase its medium term notes in Canada and, in certain circumstances, the United States.

Copies of these documents are available on www.sedar.com.

INTERESTS OF EXPERTS

Ernst & Young LLP provides the following services to our company:

(a) quarterly review of our company's consolidated financial statements;

(b) annual audit of our company's consolidated financial statements;

(c) annual audit of Hydro One Networks Inc.'s transmission and distribution businesses, Hydro One Remote Communities Inc.'s and Hydro One Brampton Networks Inc.'s financial statements; and

(d) annual audit of our company's pension fund and the following companies which hold our alternative asset investments: HOPF-HFG Investments Ltd., HOPF – HFM Investments Ltd., HOPF-PEJ Investments Ltd. and HOPF-PEP Investments Ltd.

Ernst & Young LLP is independent in Canada in accordance with its rules of professional conduct.

KPMG LLP has provided services in respect of the documentation, evaluation and enhancement of internal controls over financial reporting and disclosure controls consistent with Multilateral Instrument 52-109.

Mercer Human Resource Consulting LLC provides the following services to our company:

(a) annual accounting actuarial valuation (valuation report prepared);

(b) tri-annual funding actuarial valuation (valuation report prepared in 2004); and

(c) annual accounting actuarial valuation for supplementary pension plan for purposes of letters of credit (valuation report prepared).

ADDITIONAL INFORMATION

Additional Information about Hydro One is available on SEDAR (System for Electronic Document Analysis and Retrieval) at www.sedar.com

As our sole shareholder is the Province, we are not required to prepare an information circular. Additional financial information is contained in our audited comparative consolidated financial statements, together with the auditors' report thereon, and our Management's Discussion and Analysis for our most recently completed fiscal year, each of which may be found on SEDAR at www.sedar.com

STATEMENT OF EXECUTIVE COMPENSATION

Executive Compensation

The following table sets forth the annual compensation for the years ended December 31, 2004 to 2006 for each individual who served or acted as Chief Executive Officer or as a Chief Financial Officer during the most recently completed financial year, and for each of the three most highly compensated executive officers, other than those individuals who served or acted as the Chief Executive Officer and the Chief Financial Officer, at the end of the most recently completed financial year ("Named Executive Officers"). The information provided in the Summary Compensation Table differs from the information published under the *Public Sector Salary Disclosure Act* (Ontario) for the years ended December 31, 2004 to 2006. The differences are due to the timing of payment of incentive awards. Salary disclosures under the *Public Sector Salary Disclosure Act* are limited to amounts listed on T4 forms for each year. Information in the summary compensation table is based on the year the incentive was earned. The incentive is generally earned in one year and paid early in the following year.

Summary Compensation Table

				Annual Compensation		
	Year	**Salary**	**Bonus(1)**	**Other Annual Compensation**	**All Other Compensation**	**LTIP Payouts**
Tom Parkinson	2006	$761,786	$648,000	$139,113(3)	$3,320,000(6)	
President and Chief	2005	$780,000	$702,000	$129,630(4)		
Executive Officer (2)	2004	$750,000	$600,000	$125,923(5)		
Laura Formusa(7)	2006	$300,000	$135,000	(8)		
President and Chief	2005	$280,000	$140,000	(8)		$29,481(9)
Executive Officer	2004	$257,352	$135,000	(8)		$29,481(10)
(Acting)						
Beth Summers	2006	$320,000	$145,000	(8)		
Chief Financial Officer	2005	$280,000	$140,000	(8)		$9,466(9)
	2004	$233,750	$125,000	(8)		$9,466(10)
Myles D'Arcey	2006	$310,000	$150,000	(8)		
Senior Vice President,	2005	$285,000	$142,500	(8)		$21,793(9)
Customer Operations	2004	$220,000	$66,000	(8)		$21,793(10)
Tom Goldie	2006	$300,000	$135,000	(8)		
Senior Vice President,	2005	$280,000	$140,000	(8)		$51,987(9)
Corporate Services	2004	$268,233	$135,000	(8)		$51,987(10)
Nairn McQueen	2006	$260,000	$90,000	(8)		
Vice President,	2005	$250,000	$100,000	(8)		$21,548(9)
Engineering and	2004	$200,000	$80,000	(8)		$21,548(10)
Construction Services						

(1) This represents incentives paid under our short term incentive plan.

(2) Mr. Parkinson was appointed as President and Chief Executive Officer on April 9, 2003, effective as of January 21, 2003. On December 8, 2006, Mr. Parkinson resigned.

(3) This amount includes an executive allowance of $37,619 and payment of $49,215 under the flexible benefits program.

(4) This amount includes an executive allowance of $40,000 and payment of $40,478 under the flexible benefits program.

(5) This amount includes an executive allowance of $40,000 and payment of $41,544 under the flexible benefits program.

(6) Represents amounts paid, payable or accrued in connection with Mr. Parkinson's resignation effective as of December 8, 2006.

(7) On December 8, 2006, the Hydro One Inc. Board of Directors appointed Ms. Formusa as President and Chief Executive Officer (Acting). Previously, Ms. Formusa held the position of General Counsel and Secretary.

(8) Each of Ms. Formusa, Ms. Summers, Mr. D'Arcey, Mr. Goldie and Mr. McQueen is entitled to perquisites and other benefits in an amount that is less than $50,000 and 10 per cent of the total of his or her annual salary and bonus.

(9) This amount represents the aggregate of: (i) payment of the third and final instalment relating to the first performance period under our long term incentive plan, which was discontinued effective December 31, 2002, and (ii) payment of the second and final instalment of the second performance period thereunder for each of Ms. Formusa, Ms. Summers, Mr. D'Arcey, Mr. Goldie and Mr. McQueen.

(10) This amount represents the aggregate of: (i) payment of the second instalment relating to the first performance period under our long term incentive plan, which was discontinued effective December 31, 2002, and (ii) payment of the first instalment of the second performance period thereunder for each of Ms. Formusa, Ms. Summers, Mr. D'Arcey, Mr. Goldie and Mr. McQueen.

Hydro One has established a short-term incentive plan ("Short-Term Incentive Plan") for our executive and managerial employees, as well as separate plans for staff represented by the Power Workers' Union and the Society of Energy Professionals. See "Report on Executive Compensation – Performance Measures and Targets." However, through the collective bargaining process, the plan for Society of Energy Professional members was eliminated effective January 1, 2003, and the plan for members of the Power Workers' Union was eliminated on April 1, 2005.

The Human Resources and Public Policy Committee of our Board of Directors made a number of changes in management compensation during 2002 with respect to base salary, short-term incentive and long term incentive in order to effect cost savings. With respect to long term incentive, our Board of Directors, on the advice of the Committee, decided to discontinue our long-term incentive plan effective December 31, 2002. Any credits which had been earned by employees up until that date have been paid, as we met our financial targets for the performance periods in question. This plan provided for executive and managerial employees to receive notional incentive units in proportion to their base salaries. These units appreciated in value based on achievement of a performance goal based on cumulative net income over three year performance periods. This plan provided that awards would vest and be paid over a three-year period, provided the employee remained employed by Hydro One, unless otherwise agreed to in individual employment contracts, and provided further that the cumulative three-year net income goal was achieved. There were two performance periods introduced before the plan was discontinued. The first performance period ran from January 1, 2000 to December 31, 2002 and the second performance period ran from January 1, 2001 to December 31, 2003. 100% of the awards were to be paid out for the first performance period and two-thirds of the awards were to be paid out for the second performance period, provided that the employee remained employed by Hydro One. All payments have now been made under the plan. 229 managerial employees received payouts for the third and final instalment of the first performance period and 254 managerial employees received payouts for the second and final instalment of the second performance period. These instalments were paid in 2005.

Benefits payable under Hydro One's registered pension plan are restricted by the *Income Tax Act* (Canada). This limit on benefits affects members whose average annual earnings exceed approximately $125,000 in 2007. Participants whose pensions would otherwise be restricted by the *Income Tax Act* (Canada) participate in an unregistered supplementary pension plan that provides benefits equal to the difference between the *Income Tax Act* (Canada) maximum pension benefits and the benefits determined in accordance with the formula set out in Hydro One's registered pension plan. The supplementary pension plan is unfunded and the additional retirement income is paid from general revenues. The supplementary pension plan is secured by a letter of credit.

The following table reflects an estimate of total annual lifetime benefits payable under the Hydro One registered pension plan and the unregistered supplementary pension plan. The table as set out below assumes a normal retirement age of 65, and assumes that the maximum pensionable earnings established under the Canada Pension Plan at retirement is equal to the maximum for 2007. Retirement at an earlier age may cause benefits to be subject to an early retirement discount.

Pension Plan Table

Highest average earnings	15 years of Service	20 years of Service	25 years of Service	30 years of Service	35 years of Service
$200,000	$55,903	$74,538	$93,172	$111,806	$130,441
300,000	85,903	114,538	143,172	171,806	200,441
400,000	115,903	154,538	193,172	231,806	270,441
500,000	145,903	194,538	243,172	291,806	340,441
600,000	175,903	234,538	293,172	351,806	410,441
800,000	235,903	314,538	393,172	471,806	550,441
1,000,000	295,903	394,538	493,172	591,806	690,441
1,200,000	355,903	474,538	593,172	711,806	830,441
1,400,000	415,903	554,538	693,172	831,806	970,441
1,600,000	475,903	634,538	793,172	951,806	1,110,441

For each year of credited service under the Hydro One Pension Plan (consisting of the Hydro One registered pension plan and the supplementary pension plan), to a maximum of 35 years, the benefit provided for each of the officers who participate in the plan is equal to 2% of the member's average base annual earnings during the 36 consecutive months (60 consecutive months for management employees hired on or after January 1, 2004 and for employees represented by the Society of Energy Professionals hired on or after November 17, 2005) when his or her base earnings were highest, reduced by 0.625% of the member's average base annual earnings up to the year's maximum pensionable earnings during the 60 consecutive months when his or her base earnings were highest. Base annual earnings are comprised of the member's salary and 50% of his or her short term incentive. Unless altered by contractual agreement, the Hydro One Pension Plan provides for early retirement with an unreduced pension at the earlier of age 65 and the attainment of years of age plus continuous employment totalling 82 or more (85 for management employees hired on or after January 1, 2004 and for employees represented by the Society of Energy Professionals hired on or after November 17, 2005). A plan member who is not eligible for an unreduced pension can retire with a reduced pension any time after attaining age 55. Bridge benefits are provided to all plan members except management employees hired on or after January 1, 2004 and employees represented by the Society of Energy Professionals hired on or after November 17, 2005. Pension increases of 100% of the increase in the Ontario consumer price index (75% for management employees hired on or after January 1, 2004 and for employees represented by the Society of Energy Professionals hired on or after November 17, 2005) will be given on January 1 of each year to pensioners, beneficiaries and terminated employees with deferred pensions. The normal form of pension for a member who does not have a spouse at retirement is a pension payable for life and guaranteed for five years. The normal form of pension for a member who has a spouse at retirement is a pension payable for the life of the member, and continuing after the member's death to his or her spouse at the rate of 66 2/3% of the amount the member was receiving.

Each of the Named Executive Officers participate in the Hydro One Pension Plan. The projected credited years of service that each will have is as follows: Mr. Parkinson- 16.3 at age 65; Ms. Formusa – 35 years at age 65; Ms. Summers - 33.83 years at age 65; Mr. D'Arcey - 35 years at age 65; Mr. Goldie – 35 years at age 65; and Mr. McQueen 15.08 years at age 65.

Each of Mr. Parkinson, Ms. Formusa, Ms. Summers, Mr. Goldie and Mr. McQueen is a party to an employment agreement with Hydro One governing the terms of their employment or former employment with Hydro One, as the case may be. Each of Mr. Parkinson, Ms. Formusa, Ms. Summers, Mr. Goldie and Mr. McQueen was entitled under their respective employment agreements to the salary, benefits and pension entitlements described above. As noted above, on December 8, 2006, Mr. Parkinson resigned as President and Chief Executive Officer and Ms. Formusa was appointed President and Chief Executive Officer (Acting). No changes were made to the terms of Ms. Formusa's employment with Hydro One upon her appointment as President and Chief Executive Officer (Acting). The Board of Directors is expected to review the terms of Ms. Formusa's employment with Hydro One in the coming months.

Pursuant to the terms of Mr. Parkinson's employment agreement, Mr. Parkinson's employment was scheduled to end on January 31, 2010, unless it was extended by the mutual agreement of Mr. Parkinson and Hydro One. Pursuant to the agreement, Mr. Parkinson's base salary increased by 4% in 2005, by 3.85% in 2006 and was to have increased by 4.9% in 2007. If Mr. Parkinson's employment was terminated by Hydro One without cause, Mr. Parkinson was entitled to receive: (i) an amount equal to his base salary and executive allowance for a period of 24 months following the date of his termination (payable either in a lump sum or in equal monthly instalments over such 24-month period); (ii) full benefits for a period of 24 months following the date of his termination (payable either in a lump sum or in equal monthly instalments over such 24-month period); (iii) the payment of a bonus, being an amount that is not less than the greater of the average of the three previous bonus payments or 25% of his base salary (payable either in a lump sum or in equal monthly instalments over such 24-month period); (iv) the continuation of mortgage subsidy payments (discussed below) up to a maximum of $125,000 and (v) the reimbursement of certain relocation costs if he relocates to Australia. Mr. Parkinson was also entitled to earn credited service under the Hydro One Pension Plan during such period (discussed below). To recognize Mr. Parkinson's relocation to Canada, Hydro One agreed, during the term of his employment agreement and upon termination, to subsidize the monthly interest payable on the mortgage for Mr. Parkinson's home up to an aggregate amount of $125,000.

In addition, pursuant to Mr. Parkinson's employment agreement, Mr. Parkinson was entitled to receive the benefit of a supplemental retirement benefit, which includes pension and other benefits on the same basis as the Hydro One Pension Plan with certain enhancements. This supplemental retirement benefit provides for an unreduced early retirement pension on termination of employment at or after age 60. All such benefits paid to Mr. Parkinson under the supplemental retirement benefit will be reduced by the benefit payments made to him under the Hydro One Pension Plan when such payments are actually made. All credited service under the Hydro One Pension Plan will also be recognized as credited service under the supplemental retirement benefit plan and Hydro One will credit the supplemental retirement benefit plan for pension accrual and benefits eligibility purposes, with an additional one-half year of credited service for each year of credited service under the Hydro One Pension Plan (including the 24-month period contemplated above). In certain circumstances, including termination without cause, Mr. Parkinson will be entitled to an additional one-half year of service for each year of credited service under the Hydro One Pension Plan (including the termination period). Upon Mr. Parkinson's death, resignation, retirement or termination, with or without cause, in calculating Mr. Parkinson's benefits under the supplemental retirement benefit plan, the base earnings used in his supplemental pension payment calculations shall be deemed to be increased by $5,560 per month for the 36 consecutive months when his base earnings were highest.

In connection with his resignation, Mr. Parkinson received or is entitled to receive payment of approximately $3.3 million in the aggregate comprised of: (i) a lump sum payment in respect of his 2007 base salary and executive allowance for a period of 24 months following the date of his resignation; (ii) full benefits for a period of 24 months following the date of his resignation (payable either in a lump sum or over such 24 month period); (iii) the payment of a bonus, being an amount that is not less than the greater of the average of the three previous bonus payments and 25% of his base salary (payable either in a lump sum or over the 24 month period after his resignation); (iv) the payment of unpaid mortgage subsidy payments payable in connection with Mr. Parkinson's relocation to Canada (payable in a lump sum); and (v) certain relocation costs if Mr. Parkinson relocates to Australia. Hydro One will also credit the supplemental retirement benefit plan, for pension accrual and benefits eligibility purposes, with an additional one year of credited service for each year of credited service under the Hydro One Pension Plan, as described more fully above. Further, in calculating the benefit payable, the base earnings used in his supplemental pension payment calculations shall be deemed to be increased by $5,560 per month for the 36 consecutive months during which his base earnings were at the highest levels.

Mr. Parkinson has signed customary releases in favour of Hydro One in connection with his resignation and has agreed to keep information concerning Hydro One confidential.

With respect to Ms. Formusa, Ms. Summers, Mr. Goldie and Mr. McQueen, if their employment is terminated by Hydro One without cause, each of Ms. Formusa, Ms. Summers, Mr. Goldie and Mr. McQueen is entitled to receive an amount equal to his or her base salary at the date of termination in equal monthly instalments for a period of 24 months (18 months in the case of Mr. McQueen) and to receive benefits over the same period (including bonus payments equal to the average of the three previous bonus payments). Each of Ms. Formusa, Ms. Summers, Mr. Goldie and Mr. McQueen would continue to earn credited service under the Hydro One Pension Plan during such 24-month period (18-month period in the case of Mr. McQueen).

REPORT ON EXECUTIVE COMPENSATION

Responsibilities of Human Resources and Public Policy Committee

The mandate of the Human Resources & Public Policy Committee (the "Committee") includes reviewing the performance and remuneration of our senior executives, including recommending to the Board of Directors the remuneration of the President. In addition, the Committee is responsible for reviewing the appropriateness of our current and future organizational structure, succession plans for corporate and divisional officers, and providing advice to the Board of Directors on public affairs issues that have a significant impact on our company. The Committee is comprised of the following directors: Mr. Blake Wallace (Chair), Mr. Walter Murray, Ms.

Kathleen O'Neill (resigned January 24, 2007) and Mr. Murray Elston. The Hon. Bob Rae was appointed Chair of the Committee in 2004 and resigned on April 17, 2006.

General

The compensation of Hydro One's executive officers, including those named in the Summary Compensation Table (the "Named Executive Officers"), is determined by our Board of Directors upon recommendations made by the Committee.

Hydro One's executive compensation program is designed to establish pay levels based on performance and be competitive with Canadian utility and energy companies, both publicly and privately owned. The program is designed to attract, motivate and retain executives, critical for Hydro One's current and long-term success. This is particularly critical considering the risks associated with employee demographics and the competitiveness of the market for skilled energy sector employees. See "Risk Factors – Work Force Demographic Risk."

Approximately 25% of Hydro One's employees will be eligible for retirement by 2008. In some parts of the organization, the risk is much higher. Accordingly, company success will be tied to the ability to attract and retain sufficient qualified staff to replace those retiring. This will be challenging as the labour market for the industry is expected to be highly competitive in the future. In addition, many Hydro One employees possess experience and skills that will also be highly sought after by other organizations both inside and outside the electricity sector. Hydro One has already lost a considerable number of management staff, both those in executive positions and those who are logical successors for executive positions, to opportunities in other electricity sector positions across Canada (and, in particular, in Ontario) as well as senior positions outside of the sector.

The level of responsibility and the relative importance of positions in Hydro One are evaluated to establish appropriate reference points for internal and external comparison. To provide maximum objectivity, the evaluation of each executive officer position is determined by the Committee based on the advice of independent compensation consultants. See "Independent Advice" in this report below.

Compensation for executive officers consists of a base salary and an opportunity for an annual short-term incentive, all of which are approved by the Committee. The Committee's assessment of compensation is based on a number of quantitative and qualitative factors which include contributions to key corporate strategies and financial results. See "Performance Measures and Targets" in this report below.

Independent Advice

The Committee engages the services of an independent consultant from the Hay Group to provide advice and counsel on compensation matters, including executive compensation.

Performance Measures and Targets

Hydro One establishes its performance measures and targets on an annual basis. The Committee reviews these measures and targets, which are subsequently reviewed and approved by the Board of Directors. These measures and targets are based on Hydro One's key strategic goals in the areas of safety, customers, reliability, financial and employees. See "Description of the Business – Our Strategy."

Hydro One develops measures and targets to assess performance in all of the above strategic areas, while ensuring that the needs of key stakeholders are recognized. The Committee determined that Hydro One met or exceeded its targets in all but the Generator Customer satisfaction area in 2006, noting the improvement in a number of areas over 2005.

Safety and Employees

The potentially hazardous nature of Hydro One's business requires a strong focus on safety. In this area, Hydro One measures the high Maximum Reasonable Potential for Harm (MRPH) incidents rate to identify possible problems or situations that may increase the risk of injury. Hydro One achieved an 8.0 high MRPH rate in 2006, which is 16% lower than 2005 and 38% lower than 2003. Hydro One exceeded its target in 2006.

With respect to serious incidents in high risk areas, Hydro One focuses on electrical contacts, preventable motor vehicle accidents, work equipment failures, asset equipment failures, falling objects and falls to different levels. The number of serious incidents declined from 9.3 incidents per million hours worked in 2003, to 5.2 in 2006. Hydro One exceeded its target in 2006.

Customers

Customer satisfaction is also key to Hydro One. The Large Transmission Customer Satisfaction Survey results showed an improvement from 83% satisfied in 2005 to 86% satisfied in 2006. Hydro One has seen continuous improvement in large customer satisfaction year over year since 2002. The Residential and Small Business Customer survey results increased from 81% satisfaction in 2005 to 83% satisfaction in 2006. While 2006 Generator Customer survey results were satisfactory, they were slightly below target. The Committee found that Hydro One had met or exceeded its targets in all areas of customer satisfaction, with the exception of the Generator Customer satisfaction area.

Reliability

Reliability is influenced by weather patterns and generation constraints, requiring high performance from both the Company's transmission and distribution systems. Hydro One is conscious that businesses of all sizes require a reliable service to allow them the opportunity to deliver their products and services, and it is with these circumstances in mind that Hydro One's goal is to achieve top-quartile reliability. In 2006, Hydro One met its annual reliability targets, as well as improved on most of its results from 2005. This achievement is particularly significant bearing in mind that the targets were met while managing the impacts of a number of devastating storms throughout the year, including significant back-to-back storms experienced over the summer. Hydro One's restoration efforts were recognized by the receipt of an award from the Edison Electric Institute in Washington, D.C. Further, the North American Electric Reliability Council completed a Readiness Audit of the OGCC and gave Hydro One's transmission operations facilities, processes and staff high marks for their ability to reliably operate and maintain Ontario's electricity transmission system. See "Description of the Business – Our Transmission Business – NERC Readiness Audit". The Committee found that Hydro One had met or exceeded its targets in this area.

Financial

Finally, meeting strong financial performance is an integral part of Hydro One's business focus. In 2006, Hydro One maintained or improved credit ratings on both short-term and long-term debt. In June, Hydro One's long-term debt rating was upgraded to "A (high)" by Dominion Bond Rating Services Inc. as a result of key factors, including the expectation that Hydro One's financial profile will remain strong over the medium to long-term. The Committee found that Hydro One had met or exceeded its targets in this area.

Base Salary

The Committee establishes salary ranges for the positions held by executive officers following a review of market data from peer group, industry and national surveys provided by independent consultants. In 2002, the Committee revised the compensation policy in relation to base salary. The peer group used by Hydro One for this purpose consists of Canadian utility and energy companies, both publicly and privately owned. Hydro One's policy for base salaries for executive officers is the 75th percentile of the target market. The actual level of base salary, within the approved range for each executive officer, including the Named Executive Officers, is determined on the basis of job function and the individual's performance and experience.

Short Term Incentive

Hydro One's Short-Term Incentive Plan is a mechanism used by the Company to drive performance. There is a strong correlation between corporate performance and short term incentive payments in Hydro One. Management staff do not receive stock options and the Company no longer provides a long-term incentive. Hydro One's Short-Term Incentive Plan provides an opportunity for participants, including the Named Executive Officers, to earn an annual cash incentive payment based on both the achievement of performance targets set by the Board and on their individual contributions to these targets. Performance is measured by comparing actual results against targets established at the beginning of the year. See "Performance Measures and Targets" in this report above. Potential awards are expressed as a percentage of base salary. For the Named Executive Officers, potential awards range between 0% and 60% of base salary (between 0% and 80% of base salary for the President and Chief Executive Officer) when target performance criteria are met and subject to the discretion of the Committee. The Board of Directors, in its discretion, may provide an award over the maximum for the President and Chief Executive Officer.

Long-Term Incentive

The long-term incentive plan is described above. The plan was discontinued effective December 31, 2002 and the final payouts under the plan were made in 2005.

President and Chief Executive Officer Compensation

The pay-for-performance philosophy of Hydro One's executive compensation program applies equally to the President and Chief Executive Officer. The compensation of the President and Chief Executive Officer is recommended by the Committee and approved by the Board after careful assessment of personal contribution to the performance of Hydro One. This assessment is based on a number of quantitative and qualitative factors which include financial results, strategic planning and initiatives, personal leadership and business acumen. See "Performance Measures and Targets" in this report above.

Compensation of Directors

The by-laws of Hydro One provide that directors may receive reasonable remuneration for their services, commensurate with their duties, together with reimbursement for all reasonable expenses incurred in fulfilment of their duties, including travel expenses. The amount of such remuneration is determined by the Board of Directors from time to time. The following remuneration is currently paid to directors:

Retainer for directors	$25,000 per annum
Retainer for Committee Chairs	$3,000 per annum
Participation in Board and Committee Meetings	$900 per meeting

The fees are reviewed periodically but have not been revised since 2001. The President and Chief Executive Officer is not entitled to these fees.

Directors' fees, less statutory deductions, are paid quarterly by direct deposit or cheque as requested.

Rita Burak was appointed as Chair of our Board of Directors on May 30, 2003. Ms. Burak receives annual remuneration of $150,000 per annum, which was reduced from $250,000 per annum paid to Board Chairs in the past, and does not receive any additional fees for serving as a director.

The foregoing report has been made by the members of the Human Resources and Public Policy Committee:

Mr. Blake Wallace, Chair

Mr. Murray Elston

Mr. Walter Murray

APPOINTMENT OF AUDITOR

The auditor of our company is Ernst & Young LLP, who was first appointed as auditor on January 18, 1999.

AUDIT AND FINANCE COMMITTEE INFORMATION

The Audit and Finance Committee's Charter

Our Audit and Finance Committee's mandate is attached hereto as Appendix "A", which Appendix is hereby incorporated by reference.

Composition of the Audit and Finance Committee

The current members of our Audit and Finance Committee are Eileen A. Mercier, Murray J. Elston, Walter Murray and Douglas E. Speers. Kathleen O'Neill was a member of the Audit and Finance Committee during 2006 until her resignation effective as of January 24, 2007.

All members are independent and financially literate as such terms are defined under applicable Canadian securities legislation.

Relevant Education and Experience

In addition to each member's general business experience, the education and experience of each Audit and Finance Committee member that is relevant to the performance of his or her responsibilities as an Audit and Finance Committee member is described below.

Mrs. Mercier holds an MBA from York University. Mrs. Mercier formed her own management consulting firm, Finvoy Management Inc., specializing in financial strategy, restructuring and corporate governance issues, in 1995. From 1990 to 1995, Mrs. Mercier served as the Chief Financial Officer of Abitibi-Price Inc. In addition, Mrs. Mercier is a Fellow of the Institute of Canadian Bankers. Since 1994, Mrs. Mercier has served on the audit committees of several boards of directors and is also Chair of the Ontario Teachers' Pension Plan.

Mr. Elston has held various senior positions in the Government of Ontario including Chairman of the Management Board, Chairman of the Public Accounts Committee and Minister of Financial Institutions which involved a regulatory function with respect to financial institutions. Mr. Elston has also served in officer positions of several non-profit companies.

Ms. O'Neill is a Fellow of the Institute of Chartered Accountants. Ms. O'Neill has held various positions with BMO Financial Group and was a Tax Partner with PricewaterhouseCoopers where she provided advice on corporate structuring and international tax issues, as well as audit issues. Ms. O'Neill has served on the audit committees of several boards of directors and was the Chair of the St. Joseph's Health Centre's Audit & Finance Committee.

Mr. Murray is the former Vice-Chairman and member of the Executive Committee of RBC Capital Markets. That role included senior responsibility for relationship cover for a portfolio of major Canadian and international accounts. Since 2000, Mr. Murray has been a director of Ivernia Inc.'s Board of Directors and Chair of its Audit Committee.

Mr. Speers holds an MBA from the Richard Ivey School of Business at the University of Western Ontario. He is currently Chairman and Director of Emco Corporation and has held several senior positions with Imperial Oil Ltd. in Canada and Exxon International. He is a member of the Boards of a number of privately held companies.

Audit and Finance Committee Oversight

There have been no recommendations of our Audit and Finance Committee to nominate or compensate an external auditor which have not been adopted by our board of directors.

Pre-Approval Policies and Procedures

In accordance with the provisions of its mandate, the Audit and Finance Committee ratifies all non-audit services, as pre-approved by the Committee Chair, to be provided to the Corporation by its external auditor.

External Auditor Service Fees

(a) *Audit Fees*

The audit fees to be billed by Ernst & Young LLP for fiscal 2006 are estimated to be $895,000. The audit fees billed by Ernst & Young LLP for fiscal 2005 were $599,100.

(b) *Audit-Related Fees*

The total audit-related fees billed by Ernst & Young LLP for fiscal 2006 were $169,900. The nature of the services rendered were: accounting and internal control consultations, audit of the Hydro One Pension Plan, French translations and executive expense review.

The audit-related fees billed by Ernst & Young LLP for fiscal 2005 were $145,400. The nature of the services rendered were: accounting and internal control consultations, audit of the Hydro One Pension Plan, French translation and executive expense review.

(c) *Tax Fees*

No tax fees were billed by Ernst & Young LLP for fiscal 2006.

The tax fees billed by Ernst & Young LLP for fiscal 2005 were $1,200. The nature of the service rendered was: general tax advice.

(d) *All Other Fees*

There were no other fees billed by Ernst & Young LLP which are applicable for fiscal 2006 or fiscal 2005.

CORPORATE GOVERNANCE DISCLOSURE

Board of Directors

The Board has undertaken an independence assessment and determined that all of Hydro One's current directors are "independent" within the meaning of the rules adopted by the Canadian Securities Administrators (the "CSA"). Mr. Tom Parkinson, who was the President and Chief Executive Officer of our company and a member of Board of Directors until December 8, 2006, was not independent.

The Board has separated the roles of Chair and Chief Executive Officer. Ms. Rita Burak was appointed Chair of the Board on May 30, 2003 and is an independent director. The prime responsibility of the Chair of the Board of Directors is to provide leadership to the Board and to enhance Board effectiveness. The Chair, as the presiding member of the Board, also ensures that the relationships between the Board, management, the shareholder and other stakeholders are effective, efficient and further the best interests of our company.

Independent directors hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance. During 2006, seven such sessions without management were held. As well, the Audit and Finance Committee regularly holds such sessions with the external auditors and with the internal auditor. The Chair of the Audit and Finance Committee meets twice a year with the internal auditor. These sessions encourage open and candid discussion among the independent directors.

Summary of Attendance of Directors

The following table summarises the attendance of individual directors at meetings of the Board of Directors held for the 12-month period ending December 31, 2006.

Director	**Board Meetings Attended**
Rita Burak	15 of 15
Sami Bébawi	12 of 15
Murray J. Elston	13 of 15
Don MacKinnon[1]	13 of 14
Eileen A. Mercier	13 of 15
Walter Murray	15 of 15
Kathleen O'Neill	15 of 15
Tom Parkinson[2]	14 of 14
Hon. Bob Rae[3]	2 of 3
Kenneth D. Taylor	13 of 15
Douglas E. Speers	15 of 15
Blake Wallace	15 of 15

(1) Mr. MacKinnon was not in attendance at one Board Meeting because this meeting solely addressed labour relations matters and, as President of the Power Workers' Union, there was a conflict of interest.

(2) Mr. Parkinson was a member of the Board until December 8, 2006.

(3) Hon. Bob Rae was a member of the Board until April 17, 2006.

Directors' Board Memberships in Other Reporting Issuers

Director	**Reporting Issuer**
Rita Burak	University Health Network

Eileen A. Mercier	CGI Group Inc., ING Canada Inc., Shermag Inc., Teekay Shipping Corporation, University Health Network
Walter Murray	Ivernia Inc.
Kathleen O'Neill	MDS Inc., TSX Group Inc.
Kenneth D. Taylor	Devine Entertainment Corp., Ascendia Brands Inc.

Board Mandate

The Board of Directors is responsible for the stewardship of our company and the supervision of management of the business and affairs of our company. The Board's accountabilities and responsibilities include development of our company's approach to corporate governance, the adoption of a strategic plan and the identification of the principal risks of our company's business. The Board has adopted a Mandate, the text of which is set out as Appendix "B", which Appendix is hereby incorporated by reference.

Position Descriptions

The Board has adopted formal position descriptions for the Chair of the Board and the Board Committee Chairs. The position descriptions of each Committee Chair are set out in the Committees' mandates. In general, Committee Chairs are responsible for the leadership of their Committee as well as reporting to the Board on behalf of the Committee. The Board of Directors has also adopted a position description for the President and Chief Executive Officer, which sets out the key roles and responsibilities for that position.

Committees of the Board of Directors

The Board of Directors has established five standing committees of the Board and one ad hoc advisory committee of the Board and delegates certain of its enumerated responsibilities to each of the Committees. Notwithstanding this delegation, the Board retains its oversight function and ultimate responsibility for all matters delegated to committees.

The five standing committees of the Board are the Audit and Finance Committee, the Corporate Governance Committee, the Human Resources and Public Policy Committee, the Regulatory and Environment Committee and the Health and Safety Committee. The ad hoc advisory committee of the Board is the Information Technology Committee. The roles and responsibilities of each Committee are set out in formal written Mandates. These Mandates are reviewed at least annually to ensure that they reflect best practices as well as applicable regulatory requirements. A brief summary of each of the Committees' responsibilities follows.

Audit and Finance Committee

The Audit and Finance Committee is composed entirely of independent directors as required by the CSA rules (for more information, see the mandate of the Audit and Finance Committee which is attached). The Audit and Finance Committee oversees the integrity of accounting policies and financial reporting, internal controls, internal audit, significant corporate risk exposures, financial compliance and ethics policies.

Corporate Governance Committee

The Corporate Governance Committee is composed entirely of independent directors. The Committee acts as the nominating Committee of the Board of Directors and recommends director candidates, committee assignments, director compensation, and corporate governance policy for committees and the board as a whole. The Committee reviews the general and specific criteria applicable to candidates to be considered for nomination to the Board. The objective of this review is to maintain the composition of the Board in a way that provides the best mix of skills and experience to guide the long-term strategy and ongoing business operations of our company. In addition, the Committee leads an annual evaluation of the Board and makes recommendations on modifications of the evaluation process.

Human Resources and Public Policy Committee

The Human Resources and Public Policy Committee is composed entirely of independent directors. The Committee recommends compensation policy for senior managers, leads the performance review of the Chief Executive Officer, recommends bargaining strategy with respect to the unions, and advises the Board on public policy matters and corporate social responsibility issues. In this regard, the Committee also reviews succession planning and the recommendations for the appointment of persons to senior executive positions. In 2005, Hay Management Consultants were retained to review and provide advice on management compensation. For additional information relating to the compensation of our company's senior executives, see "Statement of Executive Compensation."

Regulatory and Environment Committee

The Regulatory and Environment Committee monitors our company's compliance with regulatory and environmental requirements and related risk, reviews related policies and generally oversees processes and procedures related to regulatory and environmental compliance at our company.

Health and Safety Committee

The Health and Safety Committee advises the Board on health and safety policies and standards, oversees compliance with health and safety regulations at our company, and reviews and reports to the Board on our company's emergency preparedness.

Information Technology Committee

The Information Technology Committee is composed entirely of independent directors and was established as an ad hoc advisory Committee of the Board specifically to assist the Board in its oversight responsibility on matters related to our company's Enterprise Application Systems Replacement Strategy.

The Enterprise Application Systems Replacement Strategy is a strategy to replace our existing customized business applications with commercially available software system applications to simplify our information technology infrastructure and improve the functionality of our business processes.

Orientation and Continuing Education

Upon joining the Board, all new directors are given a Directors Guide to provide them with an overview of the key organizational, financial, regulatory, and operational aspects of our company. The Directors Guide also contains information on the structure of the Board and its committees, committee mandates and general information on a director's obligations. In addition, new directors receive a tour of our companies' facilities and briefing sessions with senior management. Orientation sessions with senior management and facility tours provide directors with a thorough understanding of our company's business to assist them in the performance of their legal obligations and duties as directors.

On an on-going basis, as part of regular Board meetings, directors receive presentations and reports on topics related to our company's business. These information items are either suggested by management or may be requested by members of the Board. As well, directors receive information from management in response to any actions arising at a board meeting or otherwise.

Ethical Business Conduct

The Board has adopted a written Code of Business Conduct ("Code"). The Code sets out a comprehensive set of principles and expectations relating to ethical conduct, conflicts of interest and compliance with laws. The Code is part of Hydro One's internal control framework and applies to all of Hydro One's directors, officers and employees. The Code also applies to Hydro One's agents, consultants, contractors and business partners, to the extent feasible. The Code is posted on the corporate intranet site and on the external corporate website at www.HydroOne.com.

Our company has a Corporate Ethics Officer who is accountable for making sure that the appropriate actions are taken to investigate and resolve known or suspected violations of the Code, and for ensuring the tracking and reporting of all violations. The Board monitors compliance with the Code through the Human Resources and Public Policy Committee and the Audit and Finance Committee, to whom the Corporate Ethics Officer reports. The Chief Executive Officer is ultimately responsible for our company's compliance with the Code. Further, the Board of Directors abides by a conflict of interest policy which requires directors to exercise independent judgment when considering transactions and contracts in respect of which a director has a material interest.

Board, Committee and Director Assessments

A process is in place for evaluating the effectiveness of the Board of Directors and its Committees. The process consists of two written questionnaires that are completed annually by each Director. The Board Effectiveness Self-Assessment Survey addresses the areas of board responsibility, operation and effectiveness. The Individual Director Self-Evaluation Questionnaire allows each Director to identify areas for improved development and performance. The Directors' responses to the questionnaires are compiled into two summary reports that are reviewed by the Corporate Governance Committee to determine any actions that may need to be taken. The Chair of the Corporate Governance Committee provides a report on the summary reports to the Board. In addition to the written questionnaires, the Chair of the Board also meets annually with each director about individual performance and the effectiveness of the Board.

APPENDIX "A"
AUDIT AND FINANCE COMMITTEE MANDATE

1. Pursuant to By-Law No. 1 of Hydro One Inc. (the "Corporation"), a committee of the directors to be known as the "Audit and Finance Committee" (hereinafter referred to as the "Committee") is hereby established.

2. The Committee shall be composed of a minimum of four directors, and have membership attributes consistent with applicable requirements under the *Securities Act* (Ontario) and regulations thereunder including:

   - Independence. The Committee shall be comprised of directors who shall meet the independence and audit committee composition requirements set forth by applicable securities regulatory authorities, or any governmental or regulatory body exercising authority over the Corporation, as in effect from time to time. A member cannot accept consulting, advisory or compensatory fees, other than compensation for directors' fees and expenses, from the Corporation.

   - Financial Literacy. All members are to be financially literate (or shall become financially literate within a reasonable period of time after appointment to the Committee). A member is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the Corporation's financial statements.

3. The members of the Committee shall be appointed or re-appointed at the Organizational Meeting of the Board of Directors (the "Board") immediately following each annual meeting of the Shareholder of the Corporation. Each member of the Committee shall continue to be a member thereof until his or her successor is appointed, unless such member shall resign or be removed by the Board or shall cease to be a director of the Corporation. Where a vacancy occurs at any time in the membership of the Committee, it may be filled by the Board and shall be filled by the Board if the membership of the Committee is less than four directors as a result of the vacancy. Whenever there is a vacancy on the Committee, the remaining members may exercise all of the powers of the Committee as long as a quorum remains in office.

4. The Board or, in the event of its failure to do so, the members of the Committee, shall appoint a Chair from amongst their number. If the Chair of the Committee is not present at any meeting of the Committee, the Chair of the meeting shall be chosen by the Committee from among the members present. The Committee Chair shall be responsible for the leadership of the Committee, including the preparation of the agenda, presiding over meetings and determining Committee assignments. The Chair presiding at any meeting of the Committee shall have a casting vote in case of deadlock. The Committee shall also appoint a Secretary who need not be a director.

5. The time and place of meetings of the Committee and the procedure at such meetings shall be determined from time to time by the members thereof provided that:

(a) a quorum for meetings shall be three members, present in person or by telephone or other telecommunication device that permit all persons participating in the meeting to speak and hear each other;

(b) the Committee shall meet at least quarterly; and

(c) notice of the time and place of every meeting shall be given in writing or facsimile communication to each member of the Committee, the internal auditors and the external auditors of the Corporation at least 24 hours prior to the time fixed for such meeting, provided, however, that a member may in any manner waive a notice of a meeting; and attendance of a member at a meeting is a waiver of notice of the meeting, except where a member attends a meeting for the express purpose of objecting to the transaction of any business on the grounds that the meeting is not lawfully called. The Committee may request the external auditors to attend a meeting or meetings of the Committee, the expense of which shall be paid by the Corporation and included within the external auditors' annual fee. A meeting of the Committee may be called by the Secretary of the Committee on the direction of the Chair or Chief Executive Officer of the Corporation, by any member of the Committee, the external auditors or internal auditors. Notwithstanding the provisions of this paragraph, the Committee shall at all times have the right to determine who shall and shall not be present at any part of the meeting of the Committee.

6. The Committee Chair is responsible for reporting to the Board on behalf of the Committee on matters considered by the Committee, its activities and compliance with this mandate.

7. For purposes of this Section, the term "Corporation" shall include Hydro One Inc. and its subsidiary entities, as defined by Multilateral Instrument 52-110 Audit Committees.

The Committee shall:

(1) in connection with its advisory functions:

  (a) review the internal audit procedures of the Corporation and advise the Board on its auditing practices and procedures and obtain adequate assurance that internal controls are adequate;

  (b) meet separately with the external auditors and internal auditors and report to the Board on such meeting;

  (c) review the recommendations of the officers of the Corporation as to the reappointment or appointment of external auditors and make recommendations to the Board with respect to the nomination and remuneration of external auditors to be appointed at each annual meeting of the Shareholder. If a change in external auditors is proposed, the Committee will inquire as to the reasons for the change, including the response of the incumbent auditors, and inquire as to the qualifications of the newly proposed auditors before making its recommendation to the Board;

(d) review periodically, reports on the nature and extent of compliance with requirements regarding statutory deductions and remittances, including deductions and remittances under the *Income Tax Act* (Canada), the *Excise Tax Act* (Canada) and the *Unemployment Insurance Act* (Canada), the nature and extent of non-compliance together with the reasons therefore and the plan and timetable to correct deficiencies and report to the Board on the status of such matters;

(e) review and reassess the Committee's mandate at least annually and report to the Board results of the review, including any recommended changes to the mandate;

(f) the Committee shall meet with management to review and assess the process and systems in place for the review of public disclosure documents that contain audited and unaudited financial information and their effectiveness;

(g) describe in the annual information form all information about the Committee as required by applicable securities regulatory authorities; and

(h) review and assess with management and recommend to the Board for approval any material transaction, contract or other matter involving the Corporation and a shareholder, or other person, which owns directly or indirectly voting securities of the Corporation. For this purpose, "material" means any transaction, contract or matter that significantly affects, or would reasonably be expected to have a significant effect on, the financial position of the Corporation or the market price or value of its securities.

(2) In connection with the exercise of its powers:

(a) review and recommend to the Board for approval:

(i) the audited annual financial statements of the Corporation, the annual management discussion and analysis ("MD&A") and any required annual MD&A supplement and related press releases before the Corporation publicly discloses this information;

(ii) the Corporation's interim (quarterly) financial statements, interim MD&A and any required interim MD&A supplement and related press releases before the Corporation publicly discloses this information, unless the Board delegates to the Committee such approval authority as provided in paragraph (b) below;

(iii) all financial statements in prospectuses and other offering memoranda, and financial statements required by securities regulatory authorities;

(iv) the annual information form of the Corporation and any other similar disclosure required to be filed by securities regulatory authorities;

(v) any prospectus, offering memorandum of the Corporation, or any amendments thereto. For the purpose of this mandate, reference to "prospectus" includes a preliminary prospectus, a prospectus, or an amendment thereto, but excludes a pricing supplement; and

(vi) the annual financing plans and objectives of the Corporation including, foreign currency risk and interest rate risk strategies.

(b) subject to the authority delegated by the Board, review and approve the Corporation's interim financial statements, interim MD&A and any interim MD&A supplement, and review and approve the related press releases;

(c) discuss with the external auditors results of their review of the interim financial statements and interim MD&A, including any matters external auditors may raise with audit committees under generally accepted accounting principles and auditing standards in compliance with applicable securities laws and regulations;

(d) review the issuance under a shelf prospectus of the Corporation of debentures, notes and/or other unsecured and secured evidences of indebtedness of the Corporation, in accordance with the authority delegated by the Board and the filing with securities regulatory authorities of any prospectus supplement relating thereto;

(e) review and oversee the audit plans of the internal auditors and review, pre-approve and directly be responsible for overseeing the work of the external auditors of the Corporation engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the Corporation, including the resolution of any disagreements between management and the external auditors regarding financial reporting. The Committee has the authority to communicate directly with the internal and external auditors.

The Committee shall also review the degree of co-ordination between the audit plans of the internal auditors and the external auditors and will inquire as to the extent the planned audit scope can be relied upon to detect weaknesses in internal control, fraud or other illegal acts. Any significant recommendations made by the auditors for the strengthening of internal controls will be reviewed;

(f) pre-approve all audit and non-audit services to be provided to the Corporation by its external auditors. In connection with non-audit services, the Committee shall adopt specific policies and procedures for the engagement of non-audit services ensuring that the non-audit service is not prohibited or restricted by securities regulatory authorities. The Committee may also delegate to one or more of its members the authority to pre-approve audit and non-audit services, in which event the pre-approval of audit and non-audit services by any such member must be presented to and ratified by the Committee at its first scheduled meeting following such pre-approval;

(g) review the internal control procedures and management's annual internal control report to ensure compliance with the law and avoidance of conflicts of interest including, without limitation, a review of policies and practices concerning officers' expenses and perquisites, including the use of the Corporation's assets;

(h) review the duties and responsibilities of internal audit staff respecting controls, procedures and accounting practices of the Corporation;

(i) review management programs and policies regarding the adequacy and effectiveness of internal controls over the accounting and financial reporting systems within the Corporation and, in particular, the Committee will review management's response to the internal control recommendations of the internal and external auditors;

(j) receive and review regular reports from the internal and external auditors on the appropriateness of the Corporation's significant accounting and disclosure policies and practices and changes thereto, including any areas of management judgement and estimates that have a material effect upon the financial statements, alternative accounting treatments and their ramifications, disagreements between management and the internal and external auditors and include in the review a discussion with the external auditors of the quality, not just acceptability, of accounting principles, the reasonableness of significant judgements, and the clarity and completeness of disclosure;

(k) review with management, the external auditors and, if necessary, with legal counsel, any litigation, claim or other contingency, including tax assessments, that could have a material effect upon the financial position or operating results of the Corporation, and the manner in which these matters have been disclosed in the financial statements;

(l) review, at least annually, the Corporation's corporate insurance program;

(m) annually discuss with external auditors and report to the Board the auditors' independence from management and the Corporation, and in connection, request their written confirmation of independence and disclosure of relationships they have with the Corporation that may be thought to bear on independence, including non-audit related services and fees and their impact;

(n) review the minutes of any audit committee meetings of subsidiary entities of the Corporation and any significant issues and auditor recommendations concerning such subsidiary entities;

(o) review the basis and amount of the external auditor's fees in light of the number and nature of reports issued by the auditors, the quality of the internal controls, the size, complexity and financial condition of the Corporation and the extent of internal audit and other support provided by the Corporation to the external auditors and review all other non-audit fees of the auditors or other accounting firms;

(p) review management's retention of consulting and professional services, including external legal services, on an annual basis;

(q) review and appropriately address any complaints regarding accounting, internal accounting controls, or auditing matters received since the Committee's last meeting, including complaints confidentially submitted by those wishing to remain anonymous; and

(r) receive and review any reports of evidence of a material violation of securities laws or breaches of fiduciary duty tabled by the Corporation's legal counsel as a result of an inappropriate response from management.

(3) review and approve the Corporation's hiring policies regarding partners, employees and former partners and employees of the current and former external auditor of the Corporation.

(4) review, at least on an annual basis:

(a) for information purposes:

(i) the major risks to the Corporation's business objectives;

(ii) overall financing of risk, including the purchase of insurance;

(iii) the risk retention philosophy and risk tolerance guidelines; and

(iv) loss prevention policies and risk management programs;

(b) for approval by the Committee, the Corporation's enterprise risk management policy and framework;

(c) and recommend to the Board for approval all risk management strategies, including foreign currency and interest rate risk strategies.

(5) With respect to the Hydro One Pension Plan and any replacement plan thereof, review the funding policy, the audited annual financial statements, periodic

reports detailing the asset mix status and performance of the pension fund and any further pension-related reports or policies to be submitted to the Board, including those resulting from the Terms of Reference of the Pension Committee, the Pension Plan Terms of Reference of the Board of Directors, or the Terms of Reference of the Pension Investments Unit.

8. In instances where members of the Committee believe that in order to properly discharge their fiduciary obligations to the Corporation it is necessary to obtain the advice of independent counsel and other expert advisers, the Committee shall have authority to engage and compensate the appropriate experts. The Board shall be kept apprised of both the selection of the experts and the expert's findings through the Committee's regular reports to the Board.

APPENDIX "B"
HYDRO ONE INC.
BOARD OF DIRECTORS
MANDATE

DUTIES OF THE BOARD OF DIRECTORS

1. The Board of Directors of Hydro One Inc. (the "Board") is responsible for the stewardship of, and has the duty to supervise the management of, the business and affairs of the Corporation including its Subsidiaries, as defined in the *Business Corporations Act* (Ontario).

2. The Board is elected by the sole Shareholder, the Province of Ontario, as represented by the Minister of Energy (the "Shareholder"). The Board is responsible for seeking and recommending suitable Board candidates to the Shareholder.

ACCOUNTABILITIES AND RESPONSIBILITIES

The Board shall have the accountabilities and responsibilities set out below. In addition, the Board shall perform such duties as may be required under, and act in accordance with the *Business Corporations Act* (Ontario), the Corporation's by-laws, the Agreement with the Shareholder, dated October 6, 1999 (the "Shareholder Agreement"), as may be amended from time to time, and all applicable laws.

1. Corporate Governance

(a) The Board is responsible for developing the Corporation's approach to corporate governance, including developing appropriate policies and procedures and delegating such other matters as it sees fit to the Corporate Governance Committee for its review and consideration.

(b) The Board is responsible for the Corporation's approach to its governance relationship with its sole Shareholder.

2. Strategic Planning

The Board is responsible for:

(a) adopting a strategic planning process and approving, on at least an annual basis, a strategic plan which lays out the strategic direction of the Corporation in the context of the opportunities and risks of the business and the business and commercial environment in which it operates;

(b) reviewing and approving the business, financial, strategic and other plans proposed by management to enable the Corporation to execute its strategy;

(c) adopting processes for monitoring the Corporation's progress toward its strategic and operational goals, and to revising and altering its directions to management in light of changing circumstances affecting the Corporation;

(d) taking action when corporate performance falls short of its performance targets or other special circumstances warrant;

(e) approving the audited financial statements, interim financial statements and the notes and management's discussion and analysis accompanying such financial statements and the Corporation's Annual Information Form; and

(f) reviewing and approving material transactions outside the ordinary course of business, subject to the Shareholder Agreement.

3. Risk Management

The Board is responsible for:

(a) identifying the principal risks of the Corporation's business and ensuring the implementation of appropriate systems to effectively monitor and manage such risks with a view to the long-term viability of the Corporation;

(b) overseeing the integrity of the Corporation's internal control and management information systems;

(c) approving, and monitoring compliance with, all significant policies and procedures by which the Corporation is operated; and

(d) approving policies and procedures designed to ensure that the Corporation operates at all times within applicable laws and regulations.

4. Human Resources Management

(a) The Board is responsible for approving the appointment of the President and CEO. The Board is also responsible for approving the compensation of the President and CEO following a review of the recommendations of the Human Resources and Public Policy Committee.

(b) The Board will, to the extent feasible, satisfy itself as to the integrity of the President and CEO and other executive officers, and that the President and CEO and other executive officers create a culture of integrity throughout the organization.

(c) The Board is responsible for ensuring that succession planning programs are in place, including programs to train, develop, monitor and retain senior management, including the President and CEO.

5. Communications and Reporting

(a) The Board is responsible for approving and revising from time to time, a disclosure policy to address accurate and timely communications with the Shareholder, bondholders, employees, financial analysts, governments and regulatory authorities, the media and the public.

(b) The Board is responsible for overseeing the Corporation's reporting to the Shareholder, responses to requests for information and other reporting obligations as set out in the Shareholder Agreement, and for ensuring open and transparent communication with the Shareholder.

6. **Board Meetings and Materials**

(a) The Chair, in consultation with the President and CEO and the General Counsel and Secretary, shall develop the agenda for each Board meeting.

(b) Meeting materials shall be provided to directors before each Board meeting in sufficient time to ensure adequate opportunity for review.

(c) Independent directors (as defined under applicable securities legislation) shall hold regularly scheduled meetings at which non-independent directors including members of management are not present.

7. **Committees of the Board**

(a) The Board discharges its responsibilities both directly and through its committees: the Audit and Finance Committee, the Corporate Governance Committee, the Human Resources and Public Policy Committee, the Health and Safety Committee and the Regulatory and Environment Committee. In addition to these standing Committees, the Board may from time to time appoint ad hoc Committees to address certain issues of a more short-term nature.

(b) The Board is responsible for approving the mandates for each Board Committee.

(c) To facilitate communication between the Board and each Board Committee, each Committee Chair is responsible for providing a report to the Board on material matters considered by the Committee at the first Board meeting after the Committee's meeting.

DIRECTOR DEVELOPMENT AND EVALUATION

1. Each new director shall participate in Hydro One's Director Education Program and any continuing director development programs.

2. Annually, with the assistance of the Corporate Governance Committee, the Board shall evaluate and review the performance of the Board, each of its Committees, each of the directors and the adequacy of this mandate.